COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Boston Gas Company d/b/a KeySpan Energy Delivery New England	)	D.T.E. 03-40

REPLY BRIEF OF BOSTON GAS COMPANY d/b/a KEYSPAN ENERGY DELIVERY NEW ENGLAND

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I. INTRODUCTION

This is the Reply Brief of Boston Gas Company d/b/a KeySpan Energy Delivery New England ("Boston Gas" or the "Company") relating to a request for rate relief filed on April 16, 2003, in accordance with the provisions of G.L. c. 164, § 94. In this Reply Brief, the Company responds to the issues raised in the reply briefs of the intervenors, which were filed with the Department of Telecommunications and Energy (the "Department") on September 17, 2003.[1]

In particular, the Company's Reply Brief responds to the compilation of factual and legal distortions that has been presented to the Department by the Attorney General in this proceeding. The Attorney General's arguments constitute little more than an anthology of sound bites that are more appropriate for a press release than a legal brief addressing the issues that the Department must decide as it strives to fulfill its statutory obligation to adjudicate the legal and factual merits of the Company's proposal. This

[1] On September 17, 2003, reply briefs were filed by the Attorney General of the Commonwealth of Massachusetts (the "Attorney General"), the Massachusetts Division of Energy Resources ("DOER"), Associated Industries of Massachusetts ("AIM"), the Massachusetts Oilheat Council, Inc. and the Massachusetts Alliance for Fair Competition, Inc. ("MOC").

strategy is evidenced in a number of arguments, not the least of which is the Attorney General's insincere claim that, with his "appropriate" pro forma adjustments, there is a revenue surplus that would support a reduction in rates by the Department (Attorney General RB at 2-3). In fact, there is not one material adjustment offered by the Attorney General that, if adopted by the Department, would withstand review by the Supreme Judicial Court on the basis propounded by the Attorney General. Accordingly, the Attorney General should not prevail in his attempt to distort and misrepresent the record in this proceeding.

The Company will respond to each of the arguments of the Attorney General and intervenors in sequence.

II. THERE ARE NO "ACCOUNTING VIOLATIONS" AS ALLEGED BY THE ATTORNEY GENERAL

The Attorney General claims that the record shows that the Company has inappropriately: (1) "combined the books" of Essex Gas Company ("Essex"); (2) recorded costs to Account 922 (Administrative Expenses Transferred); and (3) booked Service Company costs to administrative and general accounts rather than to those costs to which they relate (Attorney General at 2). These claims have no purpose other than to create misleading perceptions and confuse the issues. The record evidence referenced by the Attorney General in making this claim (i.e., Exhs. KEDNE/PJM-1, KEDNE/PJM-2, AG-11-1, AG-23-14, AG-31-6) explains how the Company has accounted for particular costs; none of the evidence cited shows that the Company's accounting, as explained therein, is inappropriate. As discussed below, the record in this proceeding supports exactly the opposite conclusion.

A. The Books of Account for Boston Gas and Essex Are Not Combined and The Company Has Properly Accounted For All Costs

The record shows that Boston Gas and Essex are two separate companies and that the Company maintains separate books for each operation. Tr. 1, at 51. The record also shows that all costs directly incurred by Essex are recorded on the Essex books, along with all costs that are incurred by the Service Company and are directly attributable to the Essex operations (approximately $1.4 million). Exh. AG-11-1; Exh. AG-11-5; Exh. AG-11-9; Exh. AG-23-53; Tr. 1, at 13. The Company (on its own motion) identified costs totaling $425,031 that were allocated to Boston Gas by the Service Company, but were incremental to Boston Gas because the costs would not have been incurred by Boston Gas in the absence of the merger with Essex. Exh. KEDNE/PJM-2, at 26; Exh. AG-11-1; Tr. 1, at 14. The Company removed these costs from the Boston Gas cost of service and identified the costs by DTE Account in Exhibit AG-11-1. Exh. AG-23-53.

Also, at the Attorney General's request, the Company computed the portion of the general corporate and administrative costs that would be allocated to Essex (rather than Boston Gas) by the Service Company under two conditions: (1) if those allocations were required by the SEC (which they are not); and (2) if the Department's merger rulings did not exist (which they do). Exh. AG-23-53; RR-AG-35. As discussed below in Section V, these costs are non-incremental to Boston Gas because these costs would be incurred by Boston Gas even without the addition of the Essex operations. See, e.g., RR-AG-20. As a result, these costs are properly recorded on the books of Boston Gas in keeping with the directives of the Department in Eastern-Essex Acquisition, D.T.E. 98-27-A (1999).

Therefore, contrary to the Attorney General's claims, the record shows that the Company is maintaining separate books of accounts and has properly accounted for all costs in relation to the Boston Gas and Essex operations.

B. The Company Has Appropriately Recorded Costs in Account 922 (Administrative Expenses Transferred)

The Attorney General claims that the Company has inappropriately recorded costs to Account 922 (Administrative Expenses Transferred), which relates to local production and storage costs recorded on the Company's books as operations and maintenance ("O&M") expenses, but recovered through the Cost of Gas Adjustment ("CGA") factor rather than base rates (Attorney General RB at 2). The Attorney General offers no explanation as to what he considers to be inappropriate about the Company's accounting, nor does he cite any accounting rule, Department regulation or ratemaking practice that requires an accounting protocol other than that adopted by the Company.

In fact, the record evidence cited by the Attorney General shows: (1) the cost-accounting adjustments made by the Company; (2) that there is no accounting rule, policy or procedure regarding the treatment of unbundled production and storage costs; and (3) that, in any event, the amounts booked to this account are excluded from the calculation of the revenue deficiency. Exh. AG-23-14; see also Exhs. AG-13-29, AG-13-30; AG-23-9; Tr. 6, at 708-709 (explaining adjustment). Moreover, the Company's accounting procedures in relation to expenses recovered through the CGA are fully evident in the Company's annual returns to the Department, which have never been questioned by the Attorney General or the Department. Lastly, the Uniform System of Accounts, which was developed nearly 40 years ago, does not contemplate the ratemaking treatment of O&M costs that must be recovered through the CGA. Tr. 22, at

2982-84. Accordingly, there is no validity to the Attorney General's claim that the Company is out of compliance with the Uniform System of Accounts.

C. The Company Has Appropriately Recorded Service Company Charges To Administrative and General Accounts

The Attorney General claims that the Company has inappropriately recorded Service Company charges to administrative and general ("A&G") accounts rather than to those accounts "to which the costs relate" (Attorney General RB at 2). The Attorney General offers no explanation as to the basis for this claim, nor does he cite any accounting rule, ratemaking practice or Department regulation that requires an accounting protocol other than that adopted by the Company. Moreover, the testimony of the Attorney General's own witness contradicts the Attorney General's claim.

Specifically, the record shows that all costs incurred by the Service Company in providing services to its affiliated operating companies are charged to those companies using allocation formulas that apply to specific Projects and Project Activities. Exh. KEDNE/PJM-1, at 6; Exh. AG-1-28. The record further shows that, because the cost-allocation formulas differ between Projects and Project Activities, costs such as facilities costs, employee benefits and payroll taxes must be added to labor charges for each Project Activity before being allocated or charged to the operating company. Exh. KEDNE/PJM-14, at 4; Tr. 5, at 580, 584; Tr. 17 at 2307. Therefore, labor costs that, before the merger, were incurred directly by Boston Gas and charged to Account 920 and 921, are now incurred by the Service Company and charged to Boston Gas on a "fully loaded" basis reflecting the allocation percentage associated with each particular Project Activity. Exh. KEDNE/PJM-14, at 4; Tr. 17, at 2307; Tr. 25, at 3520-3521. Service Company labor charges continue to be booked to Account 920 and 921, but the

"burdens" associated with labor costs incurred by the Service Company are no longer booked to separate accounts. Exh. KEDNE/PJM-14, at 4; Exh. DTE-5-33; Tr. 17 at 2307-2308; Tr. 25, at 3519-21.

The record shows that the Attorney General's own witness concurred that the accounting rules would permit the protocol followed by the Company. Tr. 20, at 2710-2711. Specifically, the Attorney General's witness stated that:

> Q. [Keegan] So you're saying if employee costs from a service company come through an allocation back to Boston Gas, it would be inappropriate to include the pensions and benefits associated with those employees in Account 920 and 921?
>
> A. [Effron] In that circumstance, if it was billed as part of a labor billing, a totally loaded labor billing, then it could be in 920 and 921.

Id. As stated by the Company, the Department's Uniform System of Accounts provides broad guidelines on how costs are to be classified and the Company adheres to those classifications. Tr. 22, at 2983-2984. There is no evidence that the Company has failed to adhere to those classifications or that the Company has inappropriately recorded Service Company charges to Boston Gas.

The Attorney General's claims of "accounting irregularities" are completely unfounded and unsupported by the record in this case. Therefore, the alleged "accounting irregularities" provide no basis for the disallowance of costs. Moreover, the alleged "irregularities' referenced by the Attorney General are, in fact, cured by an understanding of the protocols the Company has established and followed in accounting for Service Company charges, which the record in this proceeding has provided. Therefore, no further action by the Department is necessary or warranted.

III. THE COMPANY'S SYSTEM INVESTMENTS ARE NEEDED, APPROPRIATE AND DO NOT UNDULY INCREASE RATES

In his Reply Brief, the Attorney General continues to claim that the Company has "loaded the test year" and that "delayed capital investment . . . can harm consumers, and capital investment accelerated into a test year raises cast-off rates" (Attorney General RB at 4). The Attorney General contends that the Department should therefore "set a reasonable level of plant additions" by deducting from rate base $24 million in accumulated depreciation, plus the associated balance of accumulated deferred income taxes (Attorney General RB at 6, fn.3). As with other claims made by the Attorney General, the record evidence directly contradicts the Attorney General's claim. Moreover, the legal basis for the exclusion of plant investment from rate base is a finding of imprudence, which the Attorney General does not assert. Accordingly, the Attorney General's claims must be rejected by the Department.

Specifically, there is no evidence that the Company purposely and systematically worked to increase investments to coincide with a rate case, nor does the Attorney General cite to any such evidence. The only evidence cited by the Attorney General is the total annual amount invested in plant additions. Exh. AG-1-17; Exh. DTE-4-16; Exh. DTE-4-43. However, the simple fact that the Company's system investments increased in 2001 and 2002, as compared to historical levels, is in no way indicative of a purposeful plan to "load the test year."

In fact, the record shows that KeySpan Corporation ("KeySpan") acquired Eastern Enterprises in November 2000. Exh. KEDNE/JFB-1, at 7; Exh. AG-1-2K(1)(c), at 2. The record further shows that KeySpan is a significantly larger company than Eastern Enterprises so that the capital resources available to Boston Gas for system

investments were greatly increased as a result of the merger.[2] Tr. 22, at 2927-2928. Moreover, the record shows that KeySpan approached the operation with a commitment to maintain system reliability and to achieve the benefits available to the Company and its customers through system expansion. Exh. KEDNE/JFB-1, at 8-9; Exh. AG-1-2B(1)(a), at 8; Tr. 22, at 2927. Lastly, the record shows that the level of investment committed by KeySpan will continue throughout the five-year period of the PBR Plan. Exh. AG-1-18.

Although the record is clear that the increased investment occurred at the point that KeySpan acquired the operations in 2000, and that the increased investment stems from KeySpan's greater access to the necessary financial resources, the Attorney General persists in his claim that "during the five years before the test years, the Company enjoyed higher profits under the old PBR by delaying plant improvement as customers paid automatically-increasing rates for service from an aging system" (Attorney General RB at 4-5) (emphasis added). As an initial matter, the Attorney General's presentation of Total Gas Plant Additions is flawed because (1) the amount listed in 2001 of $149 million, includes approximately $39 million in intangible plant (goodwill) that is removed from the Company's books for ratemaking purposes, and (2) the amount listed

[2] For example, in 1996 Boston Gas reported that, to meet its cash requirements, it had available up to $75 million of Eastern Enterprises "committed credit agreement" and an uncommitted line of credit. Exh. AG-1-2B(1)(g), at 6 ("Liquidity and Capital Resources"). The Company stated that it also maintained a bank credit agreement that would support the issuance of up to $70 million of commercial paper to fund gas inventories. Id. Now, as a result of the merger with KeySpan, the Company participates in a "utility funding pool" with KeySpan's other regulated operating subsidiaries. Exh. AG-1-2B(1)(a). The utility funding pool is supported by KeySpan's $1.3 billion commercial paper program, which in turn, is supported by a 364-day revolving credit agreement with a commercial bank syndicate of 16 banks totaling $1.3 billion. Exh. AG-1-2K(1)(a), at 62. In addition, it should be noted that KeySpan's total construction expenditures for 2003 are estimated to be $1.1 billion. Id. at 65.

in 2000 is actually $64 million (with goodwill of $774 million removed).[3] This means that the Total Gas Plant Additions for 2001 are approximately $111 million, which does not support the Attorney General's contention that the Company "loaded" 2001 for a rate case that the Company "planned to file" (Attorney General RB at 4).

Secondly, if there were any basis to the Attorney General's claims that the Company "delayed" plant improvements for the sake of profits during the PBR, one would expect that investment prior to the commencement of PBR would be greater than the levels following PBR. However, annual returns to the Department for the five years 1991 through 1996 show that investment levels during that time period were consistent with the levels committed by Eastern Enterprises throughout the five-year PBR period (in terms of both completed plant additions and including ongoing construction work in progress).[4]

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[3] These figures are derived as follows: (1) the goodwill adjustment per Exhibit KEDNE/PJM-2, at page 39 totals $812,950,018, of which $38,634,885 relates to 2001 and $774,315,133 relates to 2000. The $38,634,885 is derived by starting with the increase to intangibles in 2001 of $45,843,055, as set forth in the DTE Return (page 17, line 3, col. C). From this, the Company subtracted increases of $7,208,170 related to software. Exh. KEDNE/PJM-2 [supp.], at pages 00165 ($4,525,151) and 00167 ($2,683,019).

[4] The Attorney General requests that, pursuant to 220 C.M.R. §§ 1.10(2) and (3), the Department incorporate by reference or take administrative notice of the gas plant additions in the Company's annual returns for 1996 and 1997 (Attorney General RB at 5, fn.2). The Company has no objection to his request, so long as the years 1990 through 1995 are also incorporated by the Department.

Year	Total Gas Plant Additions (1)	Expenditures Including CWIP (2)
2002	$128 million	$110 million (3)
2001	$111 million	$112 million
2000	$60 million	$75 million
1999	$52 million	$57 million
1998	$51 million	$60 million
1997	$57 million	$56 million
1996	$55 million	$59 million
1995	$59 million	$57 million
1994	$60 million	$54 million
1993	$39 million	$47 million
1992	$87 million	$51 million
1991	$46 million	$57 million
Average 1996-2000	**$55 million**	**$61 million**
Average 1991-1995	**$58 million**	**$53 million**

(1) As shown on DTE Annual Return, Page 18, Line 28, Col. C
(2) As shown on DTE Annual Return, Page 18, Line 32, Col C
(3) As shown on DTE Annual Return, Page 18, Line 28, Col. C (less Line 31, Col. D).

Third, the Attorney General bases his claim that system maintenance was "delayed" exclusively on the Company's statements that, prior to the 2000/01 heating season, the Company identified approximately 1500 streets in the Boston Gas service area where distribution pressures were predicted to be below acceptable levels on a design day. See e.g., Exh. KEDNE/JFB-1, at 9. As an initial matter, the Company is at a loss to understand why the Attorney General would argue against system improvements

specifically targeted to ensure the reliability of gas service under design winter weather conditions.[5]

In addition, the Attorney General's statement that "it is not reasonable to assume that all 1,500 streets suddenly needed repair after 2000" (Attorney General RB at 5) simply ignores record evidence showing that the low-pressure areas on 1500 streets were identified as a result of upgrades to the Stoner engineering software, which enabled the Company to create simulations showing specific locations where pressure problems could be expected to occur on a design day. RR-AG-76; Tr. 12, at 1485-1487, 1522-1528. The record also shows that this upgrade accounts for the fact that no reports documenting pressure problems on these 1500 streets were available for the period prior to 2000. RR-AG-76. Therefore, the Attorney General's claim that the Company's inability to "[document] the history of the system low pressure" resulted because the Company "destroyed, lost, or failed to retain the system modeling reports on these streets for the years prior to the repairs" is inaccurate and is a patent misrepresentation of the record (Attorney General RB at 5) (emphasis added).

Lastly, the Attorney General's claims demonstrate a misunderstanding of the nature and use of the Company's Stoner model. As noted on the record, the Stoner model

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[5] On February 2, 2002, the Attorney General filed a brief with the Department in NSTAR Electric, D.T.E. 01-71A (2002), requesting that the Department levy a $22.5 million penalty on NSTAR and initiate an independent audit of the utility's ability to "carry out its public service obligation" to its electric customers in light of a "clear cutback in maintenance spending" following the merger of Boston Edison and Commonwealth Electric. NSTAR Electric, D.T.E. 01-71A (Initial Brief of the Attorney General and DOER at 6); see also, Boston Globe, February 2, 2002, at page A1. In this case, the record is uncontroverted that KeySpan acquired the Boston Gas operations in 2000, and immediately following the acquisition, began increasing investment to ensure system reliability. Exh. AG-1-17; Exh. DTE-4-19. Yet now, the Attorney General inexplicably contends that KeySpan should be penalized for that investment (Attorney General RB at 5-6, fn.3). The Attorney General cannot have it both ways. The Company requests that, pursuant to 220 C.M.R. §§ 1.10(2) and (3), the Department incorporate by reference or take administrative notice of the Attorney General's brief in D.T.E. 01-71A.

is a computer simulation tool that the Company uses to evaluate how the distribution system will perform under certain defined conditions, such as design day weather conditions, for planning purposes. RR-AG-76; Tr. 12, at 1522-1523. As a result, the model does not reflect actual or historical performance. RR-AG-76. Thus, the model runs are not "records" or "reports" under the Department record retention regulations set forth at 220 C.M.R. §75.00, and no negative inference should be drawn from the fact that the Company does not retain each and every simulation that may be run by an employee in performing his or her job function.[6]

In addition to the fact that there is no record support for the Attorney General's claims, there is also no legal basis. Under Department precedent, rate base is determined according to the cost of the utility's plant in service as of the end of the test year. Fitchburg Gas and Electric Company, D.T.E. 02-24/25, at 22; Fitchburg Gas and Electric Company, D.T.E. 98-51, at 9; Boston Gas Company, D.P.U. 96-50, at 15; Boston Gas Company, D.P.U. 93-60, at 42 (1993); Commonwealth Gas Company, D.P.U. 85-270, at 20. Year-end plant in service is included in rate base if the expenditures are prudently incurred and the resulting plant is used and useful in providing service to customers. Id. The Department considers plant to be "used and useful" if the plant is in service and provides benefits to customers. Id.

[6] The Attorney General states that the Department's record retention regulations, 220 C.M.R. § 75.00, require the Company to maintain adequate business records, and "in light of other record evidence of delayed capital investment," the Department should draw a "negative inference" from the Company's "failure" to provide documentation of system pressure (Attorney General RB at 5). However, the Attorney General cites no specific provision of the Department's regulations that the Company has failed to satisfy. Moreover, the records sought by the Attorney General did not exist prior to 2000. RR-AG-76. Accordingly, there is no basis for a "negative inference" regarding the Company's system investments.

Therefore, for the Department to disallow the Company's investment by reducing rate base for accumulated depreciation expense of $24 million, plus the associated accumulated deferred income taxes, the Department would have to find that the Company's investment was imprudent. However, with the exception of the specific projects referenced by the Attorney General in his initial and reply briefs,[7] the Attorney General has made no claim that the Company's system investments were imprudent. The Attorney General's only claim is that the Company should be penalized because the increased investment was not made by Eastern Enterprises during the period 1996 through 2000. This is not legally (or even factually) sufficient to warrant any cost disallowance, and certainly, not the cost disallowance proposed by the Attorney General.

Accordingly, there is no record or legal support for any of the Attorney General's claims that the Company has "delayed investment" or "loaded the test year.[8]" Therefore, the Attorney General's claims regarding system investment must be rejected.

IV. THE NO NET HARM STANDARD IS NOT APPLICABLE TO THE DEPARTMENT'S INQUIRY IN THIS CASE, NOR DOES THE RECORD SHOW THAT ANY HARM HAS RESULTED TO CUSTOMERS AS A RESULT OF THE KEYSPAN MERGER.

The Attorney General makes several contentions regarding the KeySpan merger in this proceeding, none of which present legitimate issues for the Department's

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7 See, Attorney General Initial Brief at 25-32 and Reply Brief at 16-23.

8 The Attorney General claims that "scheduling maintenance to coincide with the test year perpetuates harm to consumers under PBR" and that PBR is supposed to "[break] the link between costs and rates" (Attorney General RB at 6, citing Incentive Regulation, D.P.U. 94-158, at 55-57 (1997)). First, there is no record evidence that the Company "scheduled maintenance" to coincide for the test year, nor did the Attorney General allot any of his time or effort to an evaluation of the Company's maintenance schedules. Second, the Department's statements in D.P.U. 94-158 suggest that PBR may be appropriate because traditional COS/ROR regulation does not provide sufficient incentives to utility's to reduce costs. D.P.U. 94-158, at 155. The Department's order does not attempt to establish a system that divorces cost recovery from base rates as suggested by the Attorney General.

consideration. The major contentions of the Attorney General are: (1) that the Department should evaluate the Company's costs in this proceeding under the "no net harm" (public-interest) standard applied by the Department in reviewing jurisdictional mergers of regulated utility companies under G.L. c. 164, § 96 (Attorney General RB at 7-8); (2) that the Company has not met its "burden of proof" under the no net harm standard (id. at 11-12); and (3) that customers will inappropriately bear "direct and indirect costs" resulting from the merger (Attorney General RB at 8-12). All of these contentions are without record support and should be rejected by the Department.

A. The Attorney General's Argument that the Department Should Evaluate the Company's Rate Plan Using a "No Net Harm" Standard Is Legally Erroneous

Under Massachusetts law, the Department has authority to approve mergers and acquisitions between distribution companies subject to its jurisdiction. G.L. c. 164, §§ 1 and 96 ("Section 96). Section 96 states in pertinent part, that:

> Companies subject to this chapter may, notwithstanding any other provisions of this chapter or special law, consolidate or merge with one another, or may sell and convey their properties to another of such companies or to a wholesale generation company and such other company may purchase such properties, provided that such purchase, sale, consolidation or merger, and the terms thereof, have been approved at meeting called thereof, by vote of the holders of at least two thirds of each class of stock outstanding . . . , and that the [D]epartment after notice and a public hearing, has determined that such purchase and sale or consolidation or merger, and the terms thereof, are consistent with the public interest . . . .

For jurisdictional mergers, the Department has construed the public-interest standard as requiring a finding that the public interest would be at least as well served by approval of the merger proposal as by its denial. See e.g., Boston Edison Company,

D.P.U. 850, at 7-8 (1983). To satisfy this standard, the Department has stated that it will consider the potential costs and benefits of a proposed merger and that the public interest standard is a "no net harm," rather than a "net benefit" test.[9] NIPSCO/Bay State Acquisition, D.T.E. 98-31, at 8-10; Eastern-Essex Acquisition, D.T.E. 98-27, at 8; Boston Edison Company, D.P.U./D.T.E. 97-63, at 7 (1998). Alternatively, the Department reviews a utility's proposal to effect a general increase in rates pursuant to its grant of authority in G.L. c. 164, § 94 ("Section 94"), and will initiate an investigation into the Company's costs in order to render a finding that the new rates will be "just and reasonable." See e.g. Attorney General v. Department of Public Utilities, 392 Mass. 262, 265, 467 N.E.2d 72 (1984).

The Attorney General contends that the Department should evaluate the costs and benefits of the merger and apply the "no net harm" standard of review embodied in Section 96 to set the Company's rates under Section 94 (Attorney General RB at 7). In support of this argument, the Attorney General refers to Attorney General v. Department of Telecommunications and Energy, 780 N.E.2d 33 (Mass.2002). In that case, the Attorney General argued that the Department erred when it applied the no net harm standard to its evaluation of a proposed utility rate plan under Section 94,[10] in relation to the merger of BEC Energy and Commonwealth Energy Systems, both of which were public-utility holding companies not subject to regulation by the Department. Id. at 42.

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9 The Department has stated that a finding that a proposed merger or acquisition would probably yield a net benefit does not mean that such a transaction must yield a net benefit to satisfy G.L. c. 164, § 96. Eastern-Colonial Acquisition, D.T.E. 98-128, at 5, n.6.

10 The rate plan encompassed three main components: (1) a four-year freeze in distribution rates from the date of the consummation of the merger; (2) the recovery of merger-related costs through the retention of O&M savings; and (3) a service-quality plan designed to prevent any degradation in service as a result of the merger. Attorney General v. Department of Telecommunications and Energy , 780 N.E.2d 33, 36 (Mass.2002).

In its opinion, the Supreme Judicial Court squarely rejected the Attorney General's argument and found that the Department appropriately evaluated the rate plan using the no net harm standard because the rate plan sought to allow recovery of merger-related costs through the rate freeze and did not propose a general increase in rates. Id.

The Attorney General now reverses his unsuccessful argument and claims that the Court's decision stands for the proposition that the Department has authority to apply the no net harm standard in setting rates under Section 94, apparently because the rate plan involved in the SJC case involved the "***merger of holding companies***" (emphasis in original) (Attorney General RB at 7). The Attorney General offers no logic to support his claim that the standard is applicable in this case, but rather states only that the "Company has not explained why the Department, in reviewing the rate plan under similar circumstances, should not evaluate the costs and benefits of the merger" (id. at 8).

The Attorney General's contention is legally erroneous for several reasons. First, Section 96 does not provide the Department with the authority to review the merger between KeySpan and Eastern Enterprises because neither entity is regulated by the Department.[11] G.L. c. 164, § 96. In the BECo/COM case, the Department was asked to approve a rate plan that provided for the recovery of merger-related costs, including the acquisition premium through rates, and to do so, the Department applied the standard that it had developed for determining the eligibility of merger-cost recovery. Attorney General v. Department of Telecommunications and Energy, 780 N.E.2d 33, 42-43; see also, Mergers and Acquisitions, D.P.U. 93-167-A (1994). If those companies had not proposed a rate plan seeking the full recovery of merger costs through the rates of the

[11] The Department also did not have the authority to approve the merger between BEC Energy and COM/Energy, nor did those parties seek the Department's approval of their merger.

regulated utilities, the Department would not have applied the merger-cost recovery standard under Section 96 to the utility companies' rates. Accordingly, the mere fact that both cases involve the merger of holding companies does not make the cases analogous.

Moreover, contrary to the Attorney General's assertions, the Company has not made any request for the recovery of merger-related costs in this proceeding. Rather, the Department is investigating the Company's request for a general increase in rates under Section 94, which requires the Department to determine the proprietary of the proposed rates consistent with the ratemaking methodologies and precedent applicable to the ratesetting process. The SJC unequivocally stated that a company-proposed rate plan that represents a "general increase in rates" requires the Department to perform a rate investigation pursuant to G.L. c. 164, § 94. Id.; Attorney General v. Department of Telecommunications and Energy, 780 N.E.2d 33, 42. Therefore, the SJC case cited by the Attorney General directly contradicts his claim.

In fact, in a Section 94 investigation, the Department has plenary authority to investigate, evaluate and determine whether a company's costs are reasonable and prudently incurred, and therefore, the Department has the authority under Section 94 to disallow costs that are not demonstrated to be reasonable. However, if the Department were to adopt the Attorney General's standard, no jurisdictional utility would be able to change rates following a merger, unless the merger was reviewed by the Department in advance. Arguably, any cost increase following the merger (that could not be shown to have occurred in absence of the merger) would fail to meet the no net harm standard, i.e., the Department cannot effect a general increase in rates if it is applying a no net harm standard.

Therefore, by applying the Section 96 standard in a Section 94 case, the Department would create a standard that effectively requires the petitioner to demonstrate either that: (1) any and all cost increases would have occurred in the absence of the merger, or (2) that cost savings occurred following the merger to offset any cost increases that could not be distinguished from the merger. This would create an impossibly confused legal standard for setting rates under Section 94 because essentially all of the Company's costs could be argued to have been affected by the merger. This point is exemplified by the Attorney General's claim that the merger "costs" to be evaluated by the Department in this case under the no net harm standard stem from "affiliate contracts from the merger, the merger debt pushdown or the gas portfolio management and purchase gas contracts, which together make up over two-thirds of the Company's test year costs" (Attorney General RB at 7).[12] In fact, the Attorney General's legal standard would entirely subsume the Department's base-rate investigation in a Section 94 proceeding.

Accordingly, there is no legal basis to support the application of the Section 96 standard in a Section 94 proceeding. As discussed below in Section IV.C, the Attorney General seeks to apply this standard not because it is legally required, or even that it is a practical solution to ratemaking proposals of the Company, but rather, to confuse the issues in this case and to contravene the Department's application of its ratemaking precedents under Section 94. Accordingly, the Attorney General's claim that the

[12] As discussed below, the "affiliate contracts" to which the Attorney General is referring relate to the Service Company charges, which involve virtually every aspect of the Company's operations, the "push-down debt" is excluded from the cost of service, and the gas contracts have nothing to do with the base rates being established in this case.

Department should apply the Section 96 standard of review in this case is without merit and should be rejected by the Department.

B. The Attorney General Consistently Misapplies the Burden of Proof Standard

In concert with his claim that the Department should apply the Section 96 standard in this case, the Attorney General claims that the Company has failed to meet "its burden of proof" in the "absence of any concrete proof that Boston Gas has enjoyed net savings from the merger" (Attorney General RB at 11-12). In fact, the Attorney General's briefs in this proceeding are replete with arguments that the Company has failed to meet its burden of proof on numerous issues.[13] Accordingly, the Company will first address the burden of proof placed by law on the Company in a general rate proceeding that it has initiated under G.L. c. 164, § 94, and that is under investigation by the Department.

The Department has found that the burden of proof is the duty imposed upon a proponent of a fact whose case requires proof of that fact in order to persuade the factfinder that the fact exists or, where a demonstration of non-existence is required, to persuade the factfinder of the non-existence of that fact. Fitchburg Gas and Electric Light Company, D.T.E. 99-118, at 7 (2001). Proof by the preponderance of the evidence is the standard of proof generally applicable to administrative proceedings, such as a proposed general increase in rates before the Department. Id. at 7, fn.5.

Under Massachusetts law, the burden of proof is distinguishable from the burden of production.

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[13] The Company will address the specifics of each of the Attorney General's claims regarding the burden of proof in the relevant sections below.

> The burden of production is concerned with the necessity of introducing evidence in order to avoid an adverse finding. Unlike the burden of proof, which does not shift during the proceeding, *the burden of production shifts to the Company to produce evidence necessary to rebut the allegations raised against it*.

Id. at 9 (emphasis added) (footnotes omitted). The burden of production imposed on a company's proposed rate increase is generally met through the company's initial filing, which typically provides a large body of evidence to support the overall requested increase.[14] This shifts the burden of production to the Attorney General or other intervenors to submit evidence to rebut the company's initial case.[15] The Department must then determine which elements of both the Attorney General's or the Company's position are supported by the record (i.e., whether there is substantial evidence on which the Department may base a conclusion).[16] Id. If, based on the record as a whole, the Department finds that there is sufficient evidence (i.e., a preponderance of the evidence) demonstrating that the Company's proposed rates are reasonable, then the Department may order an increase in the price of the Company's distribution service. See id. See also The Berkshire Gas Company, D.P.U. 90-111, at 59 (1990) (rejecting the Attorney General's assertion that the Company's payroll allocation to non-utility operations

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14 "[U]nchallenged test year accounts may not arbitrarily be excluded from the cost of service; to the extent, and in this context, the Company's test year expenses constitute what may be styled prima facie evidence of a reasonable level of expenditures. NYNEX, D.P.U. 86-33-G, at 74, citing Fitchburg Gas & Electric Light Co. v. DPU, 375 Mass. 571, 578 (1978); Fitchburg, D.P.U. 1270/1414, at 33 (1983).

15 As a practical matter, this evidence is often developed through the discovery phase of the proceeding. As is generally the case, the Company's responses to information requests were, without objection, made part of the evidentiary record of the case. Tr. 26, at 3650.

16 In D.T.E. 99-118, the Attorney General filed a petition pursuant to G.L. c. 164, § 93 requesting an investigation into the company's 1999 electric distribution rates, rate of return, and depreciation accrual rates. The Department found that the Attorney General initially bore the burden of production relative to his allegation of over-earning. Fitchburg then responded to refute the Attorney General's evidence by introducing into the record prefiled testimony, exhibits, and the testimony of two witnesses. D.T.E. 99-118, at 9.

understates the allocation of officers' salaries to non-utility operations because "there is no record evidence to suggest that Berkshire's allocation method is flawed" or otherwise incorrectly stated).

Because a typical rate case has the potential for an extremely broad scope and volume of facts that may become "at issue," the Department has established a requirement that a company must be given sufficient notice of the issues, i.e., that certain facts are being challenged by the Attorney General or other intervening parties, *before* reaching the briefing stage of a rate proceeding. This will afford the company a reasonable opportunity to prepare and present additional evidence supporting its position. Bay State Gas Company, D.P.U. 92-111, at 6 (1992). The Department has articulated what constitutes "sufficient notice of the issues" holding that the obligation to provide notice has been fulfilled:

> where the existence of specific topics for inquiry have been noted in a previous Order; where a witness has been questioned on a particular topic; where an information request has been marked as evidence regarding an issue; or where a company has been asked to provide a witness to address a certain topic. New England Telephone and Telegraph Company, D.P.U. 86-33-D, p. 9 (1987).

D.P.U. 92-111, at 6. See G.L. c. 30A, § 11(1) ("Parties shall have sufficient notice of the issues involved to afford them reasonable opportunity to prepare and present evidence and argument"). See also The Berkshire Gas Company, D.P.U. 90-121, at 19 (1990) (stating that by raising the issue of annual growth in O&M expense in hearings, and issuing a related record request, the Attorney General provided the company with "some advance notice of an argument that could have been held until he made it on brief"). See also Western Massachusetts Electric Company, D.P.U. 88-250, at 59 (1989) (rejecting the

Attorney General's proposal to disallow all public affairs expenses because he did not take this approach during the course of the hearings and did not elicit evidence on the subject, supplying no basis on the record to support the exclusion of the public affairs expense from cost of service).

> Of course, as in all adjudicatory proceedings, the Department may only rely on substantial evidence; that is, such evidence as a reasonable mind might accept as adequate to support a conclusion. G.L. c. 30A, §§ 1(6), 14(e). Therefore, in order for a party to prevail on an issue, regardless of when the issue may have been spotlighted, that position must be supported by the record.

Bay State Gas Company, D.P.U. 92-111, at 6, fn.3 (1992).

Therefore, the Department will rule on issues on the basis of its investigation into the facts and a determination of whether those facts support acceptance or rejection of a proposal. However, the weighing of record evidence and the associated arguments of the parties should not be supplanted by an intervenor's litigation strategy that fails to develop the record or provide adequate notice to the proponent that an issue is being challenged.

In this case, Boston Gas had no legal burden in its initial filing to demonstrate "net savings" from the merger as claimed by the Attorney General, because neither KeySpan nor Boston Gas is requesting approval of the merger under Section 96 or recovery of costs relating to the merger.[17] The fact that, the Attorney General is claiming on brief that there are costs included in the Company's cost of service that are "merger-related" does not then shift the burden to the Company to show merger related savings. At most, the Attorney General's claim would shift the burden to the Company to demonstrate that the specific costs referenced by the Attorney General are not related to

[17] In fact, the record shows that the Company has excluded all merger-related costs from the cost of service. Exh. KEDNE/PJM-1, at 36.

the merger. However, for that burden to shift, the Attorney General must have provided sufficient notice to the Company by questioning a witness on that specific topic; issuing an information request on the specific topic; or asking the Company to provide a witness to address that topic. There is no information request, witness testimony or other request of the Company to demonstrate that specific costs or cost increases are unrelated to the merger. Accordingly, the Attorney General's attempt to shift the burden of proof regarding merger costs and savings to the Company is inappropriate.

C. The Attorney General's Contention That the No Net Harm Standard Should Be Applied Is Designed Only To Frustrate The Department's Investigation in this Proceeding.

In addition to being legally erroneous, the Attorney General's accusations that the Company is seeking to recover "both direct and indirect costs" from the KeySpan merger with Eastern Enterprises and that various issues should be reviewed under the no net harm standard are designed solely to frustrate and complicate the Department's cost of service investigation in this proceeding. Specifically, the Attorney General claims the Department should apply the no net harm standard to: (1) the Company's investment in the CRIS conversion (discussed in Section VI.C, below); (2) the incremental cost adjustment made in accordance with the Colonial and Essex merger orders (discussed in Section V, below); (3) all Service Company charges; (4) the asset management and gas purchase contract with Entergy Koch Trading, LLP; and (5) the debt that was incurred by KeySpan and recorded on the Boston Gas books in relation to the merger (which is excluded from the cost of service). The CRIS investment, incremental cost adjustment and Service Company charges are all subject to the Department's cost of service review under G.L. c. 164, § 94 in this proceeding. The gas purchasing contract is not related to

the merger, nor does the Attorney General even attempt to claim that it is related (see Attorney General RB at 10). The merger debt and related interest costs are excluded from the cost of service, and alternatively, merger-related savings achieved in the two years since the merger are captured in the cost of service that will underlie the rates set in this proceeding. Exh. KEDNE/PJM-1, at 36; Tr. 22, at 2970-2986, 2993-2996. Accordingly, the Attorney General's claim that the Department should apply the no net harm standard is unnecessary and unwarranted, even if it were legally applicable (which it is not). Therefore, the Department must reject the Attorney General's contention that the no net harm standard be applied to these items.

V. THERE IS NO BASIS FOR THE DEPARTMENT TO DISALLOW THE NON-INCREMENTAL COSTS INCURRED BY BOSTON GAS

The Attorney General's claims regarding the incremental cost adjustment are that: (1) "circumstances have so radically changed since the KeySpan merger and the creation of the Service Company, that they merit a fresh look" by the Department (Attorney General RB at 12-13); (2) that the Company has a "burden" to show that the creation of the Service Company maintains the "status quo" and that savings have resulted from the Essex and Colonial mergers (id. at 13); (3) that the incremental cost adjustment increases the Boston Gas cost of service, and therefore, the Company must demonstrate efficiencies to offset those costs (id. at 13-14); (4) that the Company has not shown that it has applied a "fair and reasonable criteria" by which to evaluate the allocation of costs (id. at 14); and (5) that O&M expenses have increased from the time prior to the Essex and Colonial mergers (id. at 14-15).

As discussed below, the Attorney General misses the central finding underlying the Department's incremental cost decisions, which is that the costs included in the Boston Gas cost of service are non-incremental to Boston Gas, i.e., would be incurred by Boston Gas and recorded directly onto the Boston Gas books in the absence of the mergers with Essex and Colonial. D.T.E. 98-27-A at 5; D.T.E. 98-128, at 88. As a result, rather than representing costs that the Company is "adding" to the Boston Gas cost of service, as the Attorney General contends, this cost adjustment is designed to include in the cost of service costs that rightfully belong to Boston Gas. In fact, the exclusion of these costs would effectively represent a disallowance of costs incurred to provide service to Boston Gas customers. Accordingly, none of the Attorney General's claims have any merit.

First, although the Attorney General claims that "circumstances have so radically changed," that the Department's decision in the merger cases should be reversed, the Attorney General offers no explanation as to how those changes affect, impair or change the designation of incremental or non-incremental costs. In fact, the exercise would be the same whether or not the KeySpan merger occurred. Moreover, if any change has occurred that would affect the identification of incremental and non-incremental cost it is that: (1) the Company put in place a comprehensive system to explicitly track and allocate costs, which did not exist before the KeySpan merger (Tr. 5, at 575-576); and (2) costs that would be non-incremental to Boston Gas under the Department's accounting order are allocated consistent with SEC requirements to Colonial, and therefore, must be returned to the Boston Gas cost of service in a ratemaking proceeding.

Exh. KEDNE/PJM-1, at 20; Exh. AG-11-1. The Attorney General offers no other explanation as to the changes that have occurred.

Second, the Attorney General claims that the Company has a "burden" to show that the creation of the Service Company maintains the "status quo" and that savings have resulted from the Essex and Colonial mergers (Attorney General RB at 13). There is no such burden. Pursuant to the Department's merger decisions, merger savings are shared between shareholders and customers through a 10-year rate freeze that allows customers to benefit from the avoidance of base-rate increases and shareholders to benefit from retained savings achieved through O&M expense reductions, which then offset the shareholders' costs of the merger. D.T.E. 98-27-A at 4-5; D.T.E. 98-128. There is no requirement to demonstrate savings on the Essex system, and none on the Colonial system unless and until Colonial petitions the Department for a base-rate increase following the expiration of the rate freeze approved by the Department in those merger cases. D.T.E. 98-27; D.T.E. 98-128, at 85. For Essex and Colonial customers, the status quo is maintained because they will experience no change as a result of this proceeding.

Third, the Attorney General claims that the incremental cost adjustment increases the Boston Gas cost of service, and therefore, the Company must demonstrate efficiencies to offset those costs (Attorney General RB at 13-14). However, as described above, the central tenet of the Department's findings on incremental costs in the merger proceedings was that, in order to ensure that the offset of merger-related costs and savings were preserved to give effect to the rate-freeze compacts in the Essex and Colonial mergers, Boston Gas would not be required to allocate its own fully embedded cost of service to Essex and Colonial during the rate-freeze periods. See, D.T.E. 98-27-A at 5; D.T.E. 98-

128, at 88. The record shows that the tasks performed by Boston Gas on behalf of Essex and Colonial are now performed through the Service Company (and that Boston Gas employees have been transferred to the Service Company to perform those functions). Exh. KEDNE/JFB-1, at 18; Exh. KEDNE/PJM-1, at 20. The record also shows that the Service Company allocates directly to Colonial, rather than to Boston (as it does for Essex). Exh. KEDNE/PJM-1, at 20-21; Exh. AG-11-1; Tr. 24, at 3318-3321. Therefore, these costs are actually attributable to the Boston Gas cost of service and would be part of the fully embedded cost of service if the merger with KeySpan had not occurred. In other words, these costs are non-incremental to Boston Gas and would be incurred by Boston Gas and recorded directly on the Boston Gas books in the absence of the mergers with KeySpan, Essex or Colonial. Tr. 24, at 3318-3321. As a result, the inclusion of these costs in the Boston Gas cost of service does not represent an increase to the cost of service, and therefore, there is no burden on the Company to show that Boston Gas costs have decreased by the amount of the incremental cost adjustment, as claimed by the Attorney General. In fact, the Attorney General's own witness testified that the incremental cost adjustment should not be allowed, unless the Company could demonstrate that costs have not increased since the mergers. Exh. AG-42, at 12. Accordingly, this claim must be rejected by the Department.

Fourth, the Attorney General claims that the Company has not shown that it has applied a "fair and reasonable criteria" by which to evaluate the allocation of costs (Attorney General RB at 14). In fact, there is significant explanation on the record as to the methodology applied by the Company, as discussed in the Company's Initial Brief at 9-19. See, Exh. KEDNE/PJM-1, at 20-21; Exh. KEDNE/PJM-2 [supp.], at pages 88-96;

Exh. AG-11-1; Exh. AG-11-9; RR-AG-20; Tr. 5, at 585-590. The Attorney General offers no explanation as to the deficiencies that he perceives in this analysis, other than claiming "there is no evidence that the Company conducted any study or analysis of these costs to determine the extent to which they are actually non-incremental" (Attorney General RB at 14). However, the record shows that the Company has established a comprehensive methodology and reviewed each line item of the Service Company allocations to determine whether the cost was incremental or non-incremental and has classified as non-incremental only those types of corporate and general administrative costs contemplated by the Department in its merger orders. Exh. AG-11-1; Tr. 5, at 577-588.

In addition, the Company testified that costs are tracked through the budget process, so that both cost increases and cost decreases in particular expense categories are reflected in the DTE Accounts in any given year. Exh. DTE-6-1; RR-DTE-48; Tr. 12, at 1534-36; Tr. 22, at 2969-2971; Tr. 22, at 2992-2996. The Company further testified that to evaluate costs and savings for specific expense categories (such as finance, tax preparation, human resources and the other areas referenced by the Attorney General), it would be necessary to hypothesize on what the cost-structure would be on a standalone basis, which is a virtually impossible task since you would have to make assumptions on what the costs would be absent the merger. Tr. 22, at 2997-2998. Accordingly, the only comparison that could be probative in this regard, is one that looks at overall O&M expense levels over time. The Company has presented such an analysis, which shows that A&G expenses have not increased as a result of the merger. Exh. DTE-6-1; RR-AG-101. Although these exhibits may be disputed by the Attorney General, these exhibits

afford the Department with record evidence upon which to base its decision, as opposed to the Attorney General's unsupported statement that "it is self-evident" that corporate and administrative activities will be "greater" as a result of the addition of Essex and Colonial (Attorney General RB at 14). As a result, the Attorney General has presented no evidence controverting the reasonableness of the Company's methodology to determine incremental and non-incremental cost.

Fifth, as noted above, the Attorney General contends that O&M expenses have increased from the time prior to the Essex and Colonial mergers (id. at 14-15). The Attorney General's analysis in this regard was shown to be flawed. Exh. KEDNE/PJM-14; Tr. 20, at 2696-2712. The Attorney General criticizes the Company's approach on the basis that: (1) the Company selectively eliminates expenses that have increased since the 1998 time frame (Attorney General RB at 15); and (2) has not provided a rationale for not eliminating certain other expenses that have an impact (id.). However, it is the Attorney General that is without a methodological approach on this issue.

For example, the Attorney General first claimed that "unless the Company can demonstrate that the increase in A&G expenses since the period before the merger is due to factors other than the way expenses are allocated among the affiliates, the Incremental Cost adjustment should be reversed." Exh. AG-42, at 12 (emphasis added). When the Company presented an analysis of all non-gas operations and maintenance expense accounts comparing the average O&M expense over the three-year period 1996-1998 with the total O&M for 2002, the analysis showed that without any consideration for inflation, there is a variation of only 4 percent in the 2002 expense levels, as compared to the Attorney General's 15 percent, with the elimination of pension costs, total sales

expense and system-maintenance expense (all of which are factors that are unrelated to the allocation of expenses among affiliates). RR-AG-101.

The Attorney General now claims that the Company has improperly excluded employee benefits from its analysis in RR-AG-101. There are, however, two reasons that it is improper to exclude non-pension employee benefits. First, the expense categories excluded by the Company (pensions, sales expense and system maintenance) are excluded because those accounts are non-A&G accounts that are either outside of the Company's control or not in any way affected by the cost allocations among affiliates or the rendering of corporate and administrative services by Boston Gas or the Service Company (as required by the Attorney General's witness). Exh. AG-42, at 12. To that end, non-pension employee benefits are not outside the Company's control, and in fact, could be affected as a result of the merger. In fact, the Company has an obligation to minimize health care costs, as demonstrated in this proceeding. See, e.g., Exh. KEDNE/JCO-1, at 14; Exh. DTE-2-24. Second, not all non-pension employee benefit costs are included in Account 926 (Non-Pension Employee Benefits) and the Company has repeatedly testified that the fully loaded Service Company charges are recorded in Accounts 920 and 921, which are included in the analysis, and therefore, it would improperly skew the analysis to remove non-pension employee benefits.[18] Exh; KEDNE/PJM-14, at 4; Tr. 25, at 3530-3531.

The Company does not disagree that Uncollectible Accounts could be appropriate for exclusion since these costs are somewhat outside the control of the Company and would be unrelated to the provision of corporate and administrative services and the

[18] If this expense category were to be included, then the starting point Non-Gas O&M levels must be reduced by the amount of non-pension benefit expense included in Accounts 920 and 921.

allocation of costs among affiliates; however, the Attorney General has included the wrong amount in his analysis for 2002 (Attorney General RB at 15). As discussed repeatedly on the record, this amount is actually $15,503,000, and not $6,290,000 as reported by the Attorney General. Exh. KEDNE/PJM-2, at 22; Exh. AG-23-9; Tr. 25, at 3530-3532. Therefore, if the analysis presented by the Attorney General is adjusted to eliminate the exclusion of non-pension employee benefits and to correct for the Uncollectible Accounts in 2002, the analysis would show the following:

Gas Operations and Maintenance Expenses ($000)

	2002	**1998**	**1997**	**1996**	**3-Yr. Avg.**	**Variation**
GAS O&M Per RR-AG-101, at 4	131,503	115,737	134,801	132,777	127,772	3,731 (+3%)
Less: Uncollectible Accounts	15,503	12,950	13,221	13,947	13,373	(2,180)
NET Gas O&M	116,000	102,787	121,580	118,830	114,399	1,601 (+1%)

Accordingly, the Company's analysis of all non-gas operations and maintenance expense accounts compared to the average O&M expense over the three-year period 1996-1998 with the total O&M for 2002, shows that without any consideration for inflation, there is a variation of only 1 percent in the 2002 expense levels, as compared to the Attorney General's 15 percent, with the elimination of pension costs, total sales expense, system-maintenance expense and uncollectible expense (all of which are factors that are unrelated to the allocation of expenses among affiliates). Therefore, the Attorney General's analysis only underscores the extent to which beneficial cost changes have occurred between 1996-1998 and 2002, and that those changes are not related to the

corporate and administrative functions that Boston Gas (through the Service Company) performs for Colonial and Essex.

If the incremental cost adjustment calculated by the Attorney General as relating to A&G expense is added the results are as follows:

Gas Operations and Maintenance Expenses ($000)

	2002	1998	1997	1996	3-Yr. Avg.	Variation
GAS O&M Per RR-AG-101, at 4	131,503	115,737	134,801	132,777	127,772	3,731 (+3%)
Less: Uncollectible Accounts	15,503	12,950	13,221	13,947	13,373	(2,180)
NET Gas O&M	116,000	102,787	121,580	118,830	114,399	1,601 (+1%)
Plus: Incremental Cost Adjustment (a)	8,696					
NET Gas O&M	124,696	-	-	-	114,399	10,297 (+8%)

(a) As calculated by the Attorney General (Attorney General IB at 19)

Accordingly, the Company's analysis of all non-gas operations and maintenance expense accounts compared to the average O&M expense over the three-year period 1996-1998 with the total O&M for 2002, shows that even with the addition of the incremental expense, and without any consideration for inflation, there is a variation of only 8 percent in the 2002 expense levels, as compared to the Attorney General's 15 percent, with the elimination of pension costs, total sales expense, system-maintenance expense and uncollectible expense.

Accordingly, all of the Attorney General's claims regarding the incremental cost adjustment are without merit. There is no net harm demonstrated to Boston Gas customers as a result of this adjustment and no basis for its rejection.

VI. RATE BASE

A. The Company Has Demonstrated that Its Revenue-Producing Investments Should Be Included in Rate Base.

In his reply brief, the Attorney General persists in his claims that the Department should exclude from rate base $5,941,000 in investment associated with 16 revenue producing projects (Attorney General RB at 17). The Attorney General claims that this action is warranted because the Company has not provided record support to demonstrate that the initial IRR for each project exceeded 9.38 percent; and (2) the cost increases could not have been foreseen at the outset (id. at 17). The Attorney General further contends that the Company "inexplicably failed to provide the initial IRRs . . . even when asked, and instead provided its post-construction IRRs for these projects" (id.) (citing Exh. KEDNE/PJM-10; Exh. DTE-4-31; RR-AG-59). The Attorney General then claims that the "failure" to provide pre-construction IRRs precludes an analysis of whether the costs were reasonable and prudent prior to construction, and therefore, the costs of the project should be excluded (id.). As in his Initial Brief, the Attorney General has misrepresented the record and misconstrued the Company's burden of proof in this proceeding, and therefore, has provided no legitimate basis for the exclusion of investments from rate base.

First, the Attorney General has cited no Department regulation, precedent or ratemaking practice that requires the Company to present pre-construction IRRs in the initial filing, or even that stands for the proposition that the absence of pre-construction IRRs in the record requires the disallowance of those investments from rate base. To the contrary, under Department precedent, post-construction IRRs are relied on by the Department to determine whether an investment is reasonable and prudent. See, D.P.U.

96-50, at 18 (stating that the record showed that "on an aggregate basis, . . . Boston Gas reported it achieved aggregate IRRs of 61.9 percent in 1993. . . .). In fact, the Department's entire analysis of the reasonableness and prudence of revenue-producing investments in D.P.U. 96-50 was based on post-construction IRRs and the Company followed this analysis in making this filing. Id. at 18-19, 23-24.

Second, the Attorney General misrepresents the Company's burden of proof in this proceeding. As stated above, the burden of production imposed on a company's proposed rate increase is generally met through the company's initial filing, which typically provides a large body of evidence to support the overall requested increase. D.T.E. 99-118, at 34. This shifts the burden of production to the Attorney General or other intervenors to submit evidence to rebut the company's initial case. Id. In this case, the Company provided as part of its initial filing, the post-construction IRRs for all revenue-producing investments in the years 1996 through 2002 exceeding $100,000 (including the 16 projects referenced by the Attorney General). Exh. KEDNE/PJM-10.

In that regard, the Attorney General claims that "even when asked" the Company did not produce the pre-construction IRRs. This is a patently inaccurate statement, the Company was never asked to produce these IRR calculations. First, there was no information request issued by the Department, the Attorney General or any other intervenor that requested the production of the pre-construction IRRs. The only information request cited by the Attorney General is Information Request DTE-4-31 (Attorney General RB at 17). However, this information request asks for an explanation as to the calculation of the IRRs provided in Exhibit KEDNE/PJM-10, and does not include a request to produce the pre-construction IRRs. Second, at the hearings, the

Attorney General did indeed ask the Company's witness whether the Company had provided the "original," or pre-construction IRRs, and following an off-the-record discussion, the Attorney General did not pursue this line of questioning, nor did the Attorney General make any request for these calculations. Tr. 7, at 819-821.

In addition, the record shows that the Company's witness testified that, for revenue-producing projects, the Company uses an internal threshold IRR of 11.75 percent for residential projects and 12.75 percent for commercial and industrial projects, which well exceeds the weighted cost of capital of 9.38 percent established in D.P.U. 96-50. Tr. 7, at 814-816. The Company's witness further stated that, if the pre-construction estimated rates of return do not exceed the Company's internal threshold the Company will not make the investment. Tr. 7, at 816. Therefore, by definition, the record establishes that the pre-construction IRRs of the 16 projects would well exceed the 9.38 percent claimed by the Attorney General as necessary to ensure that the investment was reasonable and prudent at the time the decision was made. Even if the production of pre-construction IRRs were a requirement to meet the Department's standard, which it is not, there is no evidence contradicting the Company's statements that it would not have commenced the 16 projects had those projects had a pre-construction IRR of less than 11.75 or 12.75 percent, as applicable. Accordingly, the Attorney General's claims that these projects must be excluded from rate base because the record does not demonstrate the pre-construction IRRs are entirely without merit.

Similarly, the Attorney General's claim that the Company has failed to meets its burden in demonstrating that the cost increases detailed by the Company could not have been foreseen at the outset is misguided and should be rejected by the Department

(Attorney General RB at 17). The Company provided the Department with all necessary documentation of the construction costs, including capital authorization and closed work order reports, and provided cost-benefit analyses for revenue-producing projects in excess of $100,000, as required by the Department. Exh. KEDNE/PJM-10; Exh AG-1-19(a); see also, D.P.U. 96-50, at 17-18. Second, the Company provided the reasons for the cost increases on specific projects about which the Attorney General inquired and this information is uncontroverted. RR-AG-59. The Attorney General does not cite to any precedent or ratemaking practice that would impose an additional burden to demonstrate the reasons for cost increases on every project about which there was no inquiry, nor does the Attorney General provide a basis for his claim that there is a burden to demonstrate that these cost increases could not have been anticipated during construction. Therefore, the record would not support a finding that the Company has acted imprudently in moving forward with these projects.

Accordingly, there is no basis upon which to rest a finding of imprudence in relation to the 16 revenue-producing projects identified by the Attorney General, and therefore the Attorney General's contention that the projects should be excluded from rate base must be rejected.

B. The Company Has Demonstrated that the West Roxbury Project was Prudent and Should Be Included in Rate Base.

The Attorney General makes the following contentions in relation to the West Roxbury project: (1) the Company has not cited to record evidence to explain the reasons for the cost increase (Attorney General RB at 18); and (2) the Company has a burden to show cost-containment measures on a project-specific basis. Both of these claims are inaccurate.

First, the Company noted in its Initial Brief that Work Order #79111, which is associated with the West Roxbury project shows that the Company installed over 1650 feet of main as compared to the 800 feet of pipe included in the original estimate. Exh. AG-1-19 (Work Order # 79111, at page 1 and 4). In addition, the record shows that the Company testified that the increased cost was not the result of a cost overrun (Tr. 7, at 811), and that there are "multiple reasons," including the installation of an additional 850 feet of main that would have accounted for the change in costs.[19] Tr. 7, at 811-812. Therefore, the Attorney General's claim that the Company has not cited to, or provided, record evidence of the cost increase is inaccurate.

Second, the case precedent cited by the Attorney General in support of his claim that the Company has a burden to demonstrate cost-containment on a project-specific basis is not applicable to non-revenue producing projects. Berkshire Gas Company, D.P.U. 92-210, at 23-24 (1993) (excluding 10 main extension projects based on ROR calculations). The Attorney General claims that the "Company's approach" would allow projects to run "far over budget, so long as the total amount invested in each year remains under the weighted cost of capital (Attorney General RB at 19). However, the "weighted cost of capital" concept is applicable to revenue-producing projects and not to non-revenue producing projects, like the West Roxbury project. D.P.U. 96-50, at 21-22. In fact, there is no case precedent supporting the proposition that cost-containment measures must be demonstrated for individual non-revenue producing projects. D.P.U. 96-50, at

[19] The Attorney General states that, "despite repeated requests" the Company has not provided any documentation for the $500,000 overrun (Attorney General RB at 19, fn.13). This statement is factually inaccurate. With the exception of questions posed to the witness during the hearings, the Attorney General never requested an explanation as to the reasons for the cost overrun. Tr. 7, at 811-812.

19-20, 24 (reviewing and accepting cost containment measures such as the use of the automated mains mapping system, formal competitive bid process; inventory purchasing practices and litigation of construction claims). As stated in the Company's Initial Brief, the Company provided ample evidence on the record regarding its cost-containment measures, which was uncontested by the Attorney General. Exh. KEDNE/PJM-1, at 49-51; Exh. DTE-4-41; Exh. AG-21-22.

Accordingly, the Company has demonstrated the reasons for the increased cost and provided documentation of its cost-containment measures. Therefore, there is no basis upon which to rest a finding of imprudence in relation to the West Roxbury project and the Attorney General's contention that the project should be excluded from rate base must be rejected.

C. The Company Has Met the Department's Standard for Inclusion of the CRIS-Related Investment in Rate Base.

The Attorney General contends that the Department should exclude the Company's $23.6 million allocation of the CRIS conversion costs from rate base because the Company has not demonstrated that the investment in the CRIS system was a prudent expenditure (Attorney General RB at 19). The Attorney General's basis for the exclusion of this investment is generally that: (1) the Company has not provided an "affirmative showing of the reasonableness" of the rate base addition (Attorney General RB at 20); (2) the Company does not cite to any cost-benefit analysis or cost-estimation analysis supporting the decision to convert from CSS to CRIS (id. at 21); and (3) the Company has not provided reviewable documentation for the investment (id. at 22). As in his initial brief, the Attorney General's arguments do not rest on, or address, the substance of

the evidence presented by the Company, and therefore, must be rejected by the Department.

First, the Company has demonstrated the reasonableness of the rate base addition because the record shows that: (1) the CSS system needed to be replaced, either through a purchase of a new system or through the conversion of the CSS data records to the CRIS system; (2) the conversion of the CSS records to the CRIS system would provide a higher level of functionality in serving customers without the purchase of a new system; and (3) the Company determined that the cost of converting the system would be significantly less than purchasing and implementing a new system with the same level of functionality. Exh. KEDNE/PJM-1, at 46-48; Exh. AG-6-87; Exh. 22-9; Tr. 7, at 806-807, 838-839; Tr. 12 at 1553. To demonstrate the prudence of this addition, the Company laid out in detail its decision-making process and the rationale that resulted in the conversion of the CSS customer-data records to the CRIS system in its initial filing. Exh. KEDNE/PJM-1, at 46-48. The Company purposely included this detailed discussion in its initial filing in response to the Department's comments in Boston Gas Company, D.P.U. 93-60, at 25, noting that the Company had included only a "paragraph" on the Company's proposed rate base addition.

Significantly, with respect to the need to replace the system, the Company faced a similar situation in D.P.U. 93-60. In that case, the Company explained that its then-existing system required replacement because: (1) it had become difficult to modify and maintain; (2) it was technically obsolete; and (3) vital parts of the system were no longer supported by the original vendor. D.P.U. 93-60, at 15. Although the Attorney General recommended disallowance of the CSS investment, the Department noted that the

Attorney General had not questioned the need for an improved system or the need to upgrade the then-existing system. Id. at 26. Accordingly, the Department found that the Company had demonstrated that the system was "rapidly reaching the point where it could no longer be modified or maintained by Boston Gas." Id. Therefore, the Department found that the Company acted prudently in determining that the billing system was in need of replacement. Id.

The circumstances are the same in this case. Specifically, the record in this case shows that, prior to the KeySpan/Eastern Enterprises merger, CSS was near the end of its useful life. Exh. KEDNE/JFB-1, at 47; Exh. AG-6-87. The record also shows that: (1) changes to the system were difficult and expensive to make; (2) the architecture of the system was founded on a database technology (the IDMS database management system) that was obsolete; and (3) because the architecture was outdated, it was no longer supported by market technologies. Id. As in D.P.U. 93-60, the Attorney General contends that the Department should disallow the investment (Attorney General RB at 23). However, as was the case in D.P.U. 93-60, the Attorney General makes no claim that the CSS system did not need to be replaced, nor does the Attorney General dispute that the CRIS system possesses a higher level of functionality than the CSS system. On brief, the Attorney General claims only that the Company's direct testimony that the CSS system was nearing the end of its useful life is "not independent and was very subjective and qualitative" (Attorney General RB at 21). However, the Attorney General never attempted to rebut the Company's testimony, nor did the Attorney General cross-examine the Company's direct testimony on the need to replace the CSS system. Therefore, the record evidence regarding the need to replace the CSS system and the increased

functionality that would result from a replacement of the system is uncontroverted on the record.[20] Exh. KEDNE/PJM-1, at 46-48; Exh. AG-6-87; Exh. AG-22-9; Exh. AG-22-1; Tr. 7, at 806-807; Tr. 12, at 1553. Accordingly, the Department should find that the Company acted prudently in determining that its billing system was in need of replacement. See, D.P.U. 93-60, at 26.

Second, the Attorney General claims that the Company does not "cite" to any cost-benefit analysis or cost-estimation analysis supporting the decision to convert from CSS to CRIS (Attorney General RB at 21). The record does not support this assertion, and in addition, the assertion belies a misunderstanding of the nature of the CRIS system investment. As discussed above, the record shows that the CSS system needed to be replaced and that this left the Company with two options, i.e., to purchase and implement a new system as it did in 1992, or to migrate the customer-data records to the CRIS system. Exh. KEDNE/PJM-1, at 46-48; Exh. AG-6-87. The Company recognized that whether it migrated the customer-data records to the CRIS system or purchased and implemented a new system, the Company would incur the costs of converting 1,395,877 current and historical customer accounts and 290,297,069 customer records to a replacement hardware/software platform. Exh. AG-6-87. However, prior to the merger with Eastern Enterprises, KeySpan invested approximately $48 million to institute the CRIS system in New York. Tr. 7, at 807; 839. Therefore, the $48 million cost of the hardware/software platform composing the CRIS system had already been absorbed by

[20] The Company's filing in this proceeding is not the first time that the Department has had the opportunity to become familiar with the rationale for the CSS data conversion or the attributes of the CRIS system. In KeySpan Energy Delivery New England, D.T.E. 02-32 (2002), the Department evaluated the Company's proposal to implement a new billing protocol as part of the CSS conversion to CRIS.

Brooklyn Union Company. Id. As a result, if the Company elected to migrate its customer records to the CRIS system, the only cost that would be incurred by Boston Gas (and the other New England gas companies) would be the costs associated with converting the New England customer records to the CRIS system and the incremental hardware/software costs associated with the development and implementation of a new system would be avoided.[21] Id.

These circumstances are not analogous to the actions taken by the Company in implementing the CSS system in 1992. As discussed in D.P.U. 93-60, the implementation of the CSS project involved the purchase, design and installation of a new database management system, as well as the purchase of a new customer-information software package. D.P.U. 93-60, at 14-17. Therefore, in reviewing the Company's actions to develop and implement the new system, the Department noted the "desirability" of using a cost-benefit analysis to evaluate the "comparative costs of maintaining an existing system versus any alternatives." Id. at 27.

In this case, the Company did not have the option of maintaining the existing system. As shown on the record, and uncontroverted by the Attorney General, the database architecture of the CSS system was becoming obsolete, was not supported by the market and was difficult to modify. Exh. KEDNE/PJM-1, at 47-51. As a result, the Company had no choice but to migrate the customer records to a new platform, with the only choice being whether to migrate those records to the CRIS system or to a new system that would serve only the New England companies. Id. In either case, the data

[21] The record shows that the costs associated with the conversion of customer records were allocated among the New England companies based on strictly on the number of customer meters since there is a direct correlation between the number of customer meters and the number of records needing to be converted. Exh. AG-6-86.

conversion costs would be incurred. Tr. 7, at 807, 839. However, as explained by the Company, the conversion of customer records to the CRIS system offered two significant benefits over a replacement system: (1) the opportunity to realize operational efficiencies as a result of the system-wide integration; and (2) costs associated with replacing the hardware/software platform would be avoided. Exh. KEDNE/PJM-1, at 48.

In addition, contrary to the Attorney General's claims, the Company has provided evidence of its cost containment efforts. As shown in Exhibit AG-6-86, the majority of the costs associated with the data conversion involve straight time labor by KeySpan employees and technical consultants retained to assist KeySpan's employees. Therefore, the primary tool used by the Company to contain labor costs was a bid solicitation process involving approximately 50 vendors. Exh. AG-6-87; Exh. AG-6-87 [supp.] (Attachment). This allowed the Company to screen candidates and to hire on a 30-day trial basis to ensure that the contractor met the Company's needs. Id.

Lastly, the Attorney General claims that the Company "must provide reviewable documentation for investments it seeks to include in rate base" (Attorney General RB at 22, citing, D.P.U. 92-210, at 24). The record shows that the Company provided a comprehensive presentation of the Job Order and Closing Report for the CRIS system detailing each individual cost item involved in the CRIS project investment, which enabled the Department to review by line item the costs that were incurred to complete the project. Exh. AG-6-86; Tr. 25, at 3404-3422; RR-DTE-107; RR-DTE-108. This report represents the most detailed financial analysis available through KeySpan financial systems without actually going back to accounts payable or payroll. Id.

Accordingly, the Company has met its burden in this proceeding for the inclusion in rate base of the CRIS system. The Company has demonstrated: (1) that its decision to replace the CSS system was reasonable and prudent; and (2) that it performed an assessment of the costs of converting the system as compared to the cost of a new system; and (3) that it provided clear and cohesive reviewable evidence on the proposed rate base addition. Moreover, the record shows that the CRIS billing system is in place providing useful services to customers. See, e.g., Exh. AG-22-1. Therefore, the investment associated with the CRIS system should be included in rate base.

VII. THE RECORD SHOWS THAT THE LOSS OF THE EXELON CONTRACT IS KNOWN AND MEASURABLE AND BEYOND THE NORMAL EBB AND FLOW OF CUSTOMERS

The Attorney General contends that the Department should deny the Company's proposed revenue adjustment to eliminate the effect of the loss of revenues associated with the Company's largest special contract with Exelon New England Holdings, LLC ("Exelon") (Attorney General RB at 25). However, record evidence demonstrates that the revenue loss associated with the Exelon contract is: (1) known and measurable; and (2) significant in amount, beyond the normal ebb and flow of customers as established by Department precedent. D.T.E. 02-24/25, at 80; D.T.E. 99-118, at 14, 20; D.P.U. 96-50, at 76, citing D.P.U. 95-118, at 130, D.P.U. 1270/1414, at 20 (see also Exh. DTE-5-13).

The Company has demonstrated that the loss of revenues associated with the Exelon contract is known and measurable. Specifically, under the existing contract, the Company provides firm transportation service to Exelon's New Boston and Mystic 7 generating units. Exh. KEDNE/AEL-1, at 9. The Company presented the Department with a copy of the most recent amendment to the contract, approved by the Department,

which states that the contract will terminate no later than March 31, 2004, and possibly before that date, upon 60 days notice by Exelon. Exh. AG-1-99, at Bates Stamp 00466). The record shows that the addition of the 60-day notice provision was expressly required by Exelon in entering into the amended contract. Tr. 6, at 666. The Company also presented public statements by Exelon that it intends to close the New Boston facility. Exh. AG-8-39.[22]

Moreover, the Company demonstrated that the loss of revenue is beyond the level of revenue lost due to the normal ebb and flow of customers. Specifically, the Company demonstrated that the $3.7 million in revenues associated with the Exelon contract represents approximately 22 percent of the Company's revenues from special contracts. Exh. AG-19-12 **[confidential]**; Tr. 7, at 776. The record also shows that the lost revenues represent 4.1 percent of the Company's gas industrial class operating revenues.[23] Exh. AG-1-2B(8)(a), at 43. Moreover, the margin associated with the Exelon Contract is three and a half times larger than that of the contract's replacement (the Distrigas contract).[24] Id.; see also Exh. KEDNE/AEL-2, at 8.

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22 Specifically, Exelon has stated publicly that, once its Mystic 8 and 9 facilities commence operation, there would be no need to run its New Boston facility. Exh. AG-8-39; Tr. 6, at 668. The Mystic 8 and 9 facilities are now on line. Accordingly, it is the Company's expectation this event will result in the closing of the New Boston plant.

23 In D.T.E. 99-118, the Department found that the loss of Princeton Paper Company represented a significant loss to the company based, in part, on an analysis of the percentage of industrial class operating revenues that the Princeton Paper Company special contract represented. D.T.E. 99-118, at 18.

24 The Attorney General claims that the Company has not "justified the disparity in revenue levels based on the much lower prices supplied by Distrigas" (Attorney General at 23-24). Aside from the fact that the Company has no burden to "justify" differences in revenue levels among contracts, the simple explanation is that these are two separate contracts and all special contracts are priced to recover the marginal investment and operations and maintenance costs needed to provide service to the customer under the contract. Exh. AG-1-99; Tr. 6, at 650.

The Attorney General further claims that, for ratemaking purposes, special contract revenues are "treated as offsets to costs, not contributions to shareholder profits" (Attorney General RB at 24). Therefore, the significance of any loss should be measured in terms of distribution tariff-rate revenue requirements, not "before-tax income" (id.). These statements simply makes no sense, because the loss of this customer following the Department's establishment of new rates (should the Department decide not to eliminate these revenues from the revenue requirement) would be a direct reduction to the Company's earnings of 5.2 percent. Tr.7, at 776.

Accordingly, the Company has demonstrated that this revenue adjustment meets the Department's standard for known and measurable post-test year changes and should be allowed.

VIII. EXPENSES

A. The Attorney General's Recommendation on the Amortization of Intangible Plant Is Not Supported By the Record.

The Attorney General contends that the Department should remove $266,000 from the Company's pro forma amortization expense because "the nine software packages themselves are not recurring, and will be fully amortized by July 1, 2004" and the Company has not demonstrated that this amount will be representative "in every year" of the PBR Plan (Attorney General RB at 25). The Attorney General's claims are erroneous in several respects.

First, the Attorney General has misstated the Department's standard. Specifically, the Company has no obligation to show that the costs will be representative in "every

year" following the establishment of rates.[25] Rather, the Department's standard is that test year expenses that recur on an annual basis are eligible for full inclusion in the cost of service unless the record supports a finding that the level of the expense in the test year is abnormal. Fitchburg Gas and Electric Light Company, D.P.U. 1270/1414, at 33 (1983). If such a finding is made, the Department will normalize the expense to reflect the amount that is likely to recur on a (normal) annual basis. Id. The Attorney General has not alleged that these costs are "abnormal," just that the amortizations will end in July 2004. This is not sufficient to overcome the presumption of reasonableness.

Second, there is no burden to show that a particular amortization item is non-recurring, only that the expenses are recurring. The record shows that the Company has capitalized software additions every year (e.g., 12 in 2002, 8 in 2001). Exh. KEDNE/PJM-2 [supp.], at 164-167. Therefore, the Company has presented record evidence establishing the representative level and the recurring nature of the expense. Accordingly, the Attorney General's recommendation to reduce the Company's unamortized non-informational software balance by $266,000 to an annual level of $155,000 is unfounded and must be rejected by the Department.

B. The Pension Expense Included in the Company's Cost of Service is Calculated Consistent with Department Precedent and Is Appropriate for Inclusion in Rates.

1. The Company's Pro-Forma Pension Expense Is Reasonable.

In his reply brief, the Attorney General repeats his arguments that contributions to the pension fund in 2001 and 2002 include a "catch-up" for zero funding in earlier years

[25] This argument is ironic coming from the Attorney General, who is arguing the alternative in relation to the establishment of a representative amount of pension expense ($10 million) that falls significantly below the post-test year pension expense for 2003 demonstrated on the record ($17 million). Tr. 20, at 2746-2748.

(i.e., 1998 and 1999), and therefore, these catch-up payments are not representative of the Company's annual pension contributions (Attorney General RB at 26-27). However, rather than relying on record evidence, the Attorney General turns to "logic," suggesting that "[l]ogically, if the contributions in 1998, 1999, and 2000 had been greater than zero, then the unfunded liability as of 2001 and 2002 would have been less" resulting in greater contributions in later years (id. at 27). The implication of the Attorney General's argument is that the Company purposely underfunded the pension funds in 1998 through 2000, which led to larger "catch-up" contributions in subsequent years. There is no record support for this contention.

The record shows that maximum and minimum tax-deductible contribution levels are established in accordance with Internal Revenue Service ("IRS") rules and that these contribution levels are driven by the funded status of the pension trust fund, which is a function of financial-market performance and interest rate levels as much as it is the Company's contribution levels. Exh. KEDNE/JFB-1, at 31. No contributions were required in 1998, 1999 and 2000 because of the strong fund performance and the resulting impact on the tax deductibility of contributions. Exh. KEDNE/PJM-1, at 15. Therefore, the only "catch-up" that is occurring is to improve the funded status of the trust funds. Id.

In addition, the Company's average of the past three years of cash contributions to its pension fund ($44.5 million in 2002, $19 million in 2001 and $0 in 2000) is more representative of the Company's future obligations than an average of the past five years cash contributions because of the fundamental change in the returns previously earned by the plan in the stock market. The Attorney General does not dispute that the Company's

cash contributions have increased more recently to address the overall decline in the plan's assets (e.g., equity assets) and projected funding needs (as affected by the assumed discount rate). This decline, which is not unique to the Company, reflects the experience of the U.S. economy over three consecutive years of declining equity-markets and falling interest rates. Exh. KEDNE/JFB-1, at 34. To use a five-year average, which includes three years when absolutely no contribution was made to the plan, would skew the test-year level well below the more recent trends that have evolved in the market and corresponding funding status of the plan.

Second, the Attorney General argues that the Department should adopt Mr. Effron's "estimate" of the FAS 87 pension cost for 2003 because the use of a 6.86% percent discount rate (rather than the Company's rate of 6.75 percent) "did not have a material effect on the calculation of FAS 87 expense (Attorney General RB at 27). The Attorney General states that the effect of this substitution was approximately $200,000 out of a total pension cost of $12,581,000, and that "other than this minor criticism," the Company offered no substantive criticism of Mr. Effron's FAS 87 pension expense (id.).

As with other statements of the Attorney General, this statement is inaccurate and misleading. In fact, the Company testified that the effect of using a higher discount rate is to reduce the pension expense, and therefore, the effect of Mr. Effron's change was to reduce his calculation of the pension expense by $1.2 million in comparison to the Company's amount. Tr. 22, at 3067-3068. Moreover, the Company's initial brief reflected the "substantive" arguments that: (1) Mr. Effron conceded that he "backed into the semiannual compounding" (Tr. 20 at 2665); (2) the Company's 2003 pension expense will be $17,366,106, as determined by its actuarial analysis (Exh. AG-11-13; Exh.

KEDNE/JFB-1, at 35; Tr. 22, at 3003-3004); and (3) Mr. Effron could not support the use of a 6.86 percent discount rate to calculate pension expense and no record evidence supports the use of this amount (RR-AG-83). As a result, the FAS expense calculated by Mr. Effron is, in fact, a meaningless number, since he has simply manipulated the assumptions used in determining FAS 87 expense to arrive at a number that was comparable to the five-year average of cash contributions (see Company IB at 79).

Lastly, the Attorney General "notes" that "KeySpan has told its investors that it has no plans to make any contributions to its employee retirement trust funds for the year 2003 as a result of the return it has received from the stock market" (Attorney General RB at 27, fn.18, citing Exh. AG-1-2 (KeySpan 2002 Form 10-K, at 60). Again, this statement is a patent distortion of the record. However, the actual statements of KeySpan in the 2002 Form 10-K are as follows:

> Historically, we have funded our pension plans in excess of the amount required to satisfy minimum ERISA funding requirements. At December 31, 2002, we had a funding balance in excess of the ERISA minimum funding requirements and as a result KeySpan will not be required to make any contribution to its pension plans in 2003. However, although we have presently exceeded ERISA funding requirements, our pension plans, on an actuarial basis, are currently underfunded. Future funding requirements are heavily dependent on actual return on plan assets. Therefore, if the actual return on plan assets continues to be significantly below the expected returns, we may elect to fund the pension plans in 2003.

(Exh. AG-1-2, KeySpan 2002 Form 10-K, at 60) (emphasis added). Accordingly, the Attorney General's claims are not credible on this issue, and the Department should reject the Attorney General's recommendations on the establishment of a representative level of pension expense in rates.

2. The Department Should Not Reduce the Company's Cost of Equity Upon the Approval of the Pension Adjustment Mechanism.

Without offering any rebuttal to the Company's arguments in support of the pension reconciliation mechanism, the Attorney General repeats his contention that, if the Department approves the Company's proposed reconciliation mechanism, it should reduce the Company's cost of equity by 0.5 percent to reflect a reduction in risk (Attorney General RB at 28). However, based on the record in this proceeding, a decision to adopt the Attorney General's recommendation would constitute an error of law because there is not substantial evidence on the record to support such an adjustment.

The evidence on the record is as follows:

(1) Mr. Moul testified that the approval of the Company's pension mechanism will not decrease the risk to investors in the Company's common stock. Exh. KEDNE/PRM-4, at 2-3. Mr. Moul's testimony states that, if anything, the implementation of the reconciliation mechanism will only maintain the *status quo*:[26]

> [I]t is my opinion that the approval of the mechanism proposed by Boston Gas *will maintain the status quo* for the Company and its customers so as to avoid penalizing the Company as a result of including in rates a level of pension expense that is too low, or penalizing customers if the amount included in rates were set too high.

Exh. KEDNE/PRM-4, at 3 (emphasis added). As noted by the Company, this means that the Company's risk would actually increase as a reaction to a lowered rate of return that *removes* a risk premium for pensions where none now exists. Tr. 13, at 1728-1734.

[26] The Attorney General offers the comment that "if there is not presently a pension reconciliation adjustment mechanism in place, then obviously prospective implementation of such a mechanism will alter the 'status quo'" (Attorney General RB at 28). However, Mr. Moul's statements refer to the traditional cost of service ratemaking context where it is possible to set a representative level of costs in rates that do not unfairly penalize either the Company or its customers, and not to the existence or non-existence of the reconciliation mechanism. See, Exh. KEDNE/PRM-4, at 2.

(2) Mr. Moul testified unequivocally that there is no change warranted in the cost of equity for the Company if the Department approves the pension mechanism. According to Mr. Moul, financial markets have yet to place a risk premium (reflected in the data for the Barometer Group) on pension cost recovery because this issue is just now emerging in the public's awareness. Exh. KEDNE/PRM-4, at 3. If there is no risk premium currently required by investors associated with pension cost recovery, then there is no basis to remove (i.e., reduce) any premium from the cost of equity (id.). "No adjustment to the 12.18 percent return on common equity that I have recommended would be necessary or appropriate" (id.).

(3) The record shows that companies within Mr. Moul's Barometer Group currently have in place non-traditional mechanisms to account for pension costs. RR-DTE-63.

(4) There is no record evidence to support a reduction in the return on equity, or to support a reduction in the return on equity of 0.5 percent (or any other percent), as proposed by the Attorney General. In response to examination by the Department, the Attorney General's witness testified that:

> **Q. If you go on Page 5 of your testimony, you state that if the Department approves the company's proposed pension reconciliation mechanism, you must make an adjustment to the company's cost of capital. Do you have an assessment as to what type of adjustment would be necessary -- besides the fact that it would be going down? I'm just looking for if you have a sense of the order of magnitude of how many basis points we might be looking at.**
>
> A. I've been looking for a measurement out there. There aren't a lot of companies that have this type of adjustment, and it's difficult to measure, if you will, on a market perspective, because there aren't enough companies out there to get what I call a reliable measure. Even those companies that -- for instance, the ones that Mr. Moul

> identified in his barometer group, the manner in which the mechanisms were established weren't, if you will, isolated enough so that you can say that that one item can be identified with a particular change in basis points in cost of equity. I am struggling with it. I know it's more than one basis point. Is it 200 basis points? I don't think so. I believe that it's somewhere between 100 and zero, and it could depend on – I believe it does depend on, to a certain extent --the company itself. As you go across the different companies that we have in Massachusetts, some companies are a lot better off than others. So it can depend on the company, too.

(Tr. 26, at 3560-3561). Based on this analysis, the Attorney General concludes that if the Department were to find that the cost of common equity was 10.5 percent, then the Company's cost of equity (with the pension adjustment mechanism) "must necessarily" be reduced *"to say 10 percent"* (Attorney General RB at 28) (emphasis added).

The statement of the Attorney General's witness above represents the sum total of the "evidence" that could be cited to support a reduction in the return on equity, and it is not sufficient to withstand judicial review. In Boston Gas Company v. Dep't of Telecommunications and Energy, 436 Mass. 233, at 241 (2002), the Supreme Judicial Court stated, in relevant part:

> While we recognize that some uncertainties cannot be precisely quantified, we do require more than a conclusory statement to that effect.

Id., citing Massachusetts Inst. of Tech. V. Department of Pub. Utils., 425 Mass. 856, 870 (1997).

Accordingly, the Attorney General's proposed reduction in the Company's cost of capital based on the Department's approval of the Company's pension adjustment mechanism should be rejected.[27]

3. The Company Should Recover Carrying Charges on its Prepaid Pension Funds.

The Attorney General contends that the Company should not be permitted to recover a return on prepaid pension balances if the Department approves the Company's pension adjustment mechanism (Attorney General RB at 29). The Attorney General argues that the Company has not cited any precedent for allowing a return on prepaid pension expense (id.). However, the absence of a direct precedent, by itself, is not determinative where the Company's position has merit.[28]

The Attorney General does not contest the fact that in many orders over the years, the Department has indicated that it is appropriate for companies to make cash contributions to its pension and PBOP funds equal to the maximum allowable tax deductible amount (even where the amount contributed exceeded the SFAS 87 booked amounts).

> The Department encourages companies to take optimum advantage of the benefits attendant to the funding of PBOPs. Tax-free accumulation of assets in a trust with appropriate safeguards should ultimately result in lower overall PBOP costs for ratepayers.

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[27] Conversely, were the Department to reject the Company's pension adjustment mechanism, the Department should increase the allowed cost of equity to reflect the increased risk of recovery of pension expenses.

[28] The Attorney General also argues that the carrying charges on prepayments do not represent the difference between cash contributions and the amounts recovered in rates (id.). The Attorney General argues that the prepayment amount is the difference between the cash contributions and the FAS expense. However, the Attorney General ignores the second element of the carrying charge calculation included in the mechanism, i.e., the unrecovered deferral of the difference between what is recovered in rates and the FAS expense. Exh. KEDNE/JFB-2. The combination of the two elements totals the net difference between the amount contributed and the amount collected in rates (Company IB at 199-200).

Cambridge Electric Light Company, D.P.U. 92-250, at 54 (1993). See also Bay State Gas Company, D.P.U. 92-111, at 226 (1992) and Massachusetts Electric Company, D.P.U. 92-78, at 83 (1992) (the Department finds that funding at levels equal to the maximum allowable tax deductible amount strikes the best balance between the interests of ratepayers and shareholders). Given the Department's long history of encouraging companies to contribute funds in excess of FAS 87 expense amounts (i.e., prepayments), it would be contradictory, if not confiscatory, for companies who have complied with the Department's encouragement to be denied a carrying charge on the use of these funds.

When a prepaid asset account is created for pension costs, the Company's funds are put aside to meet pension obligations and are not available to the Company for other purposes. Exh. KEDNE/JFB-1, at 42. Therefore, the pre-funding or prepayment of pension obligations is cash that has been provided from Company funds through borrowings and/or advances from the Company's shareholders (id.). As a result, there is a cost associated with using the Company's capital resources to pre-fund the pension obligation.[29]

> Without consideration of the Company's cost of capital, the tax-deductible funding of the pension plan represents an interest-free loan to customers. The Company is entitled to earn its cost of capital on the funds that it uses to invest in, and operate, the gas-distribution business. Therefore, if the Company use its available capital resources to contribute to the pension fund, it should be compensated for the cost of capital associated with those prepayments, just as it receives the cost of capital on other types of prepayments made in the course of providing service to customers.

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[29] FERC precedent has also permitted carrying charges on prepaid pension expenses. Cities of Greenwood and Seneca, South Carolina v. Duke Power Company, 77 FERC ¶ 63,017 at Item 14 (Initial Decision) (1996). Even though such prepayments were not required by law, the decision allows carrying charges because the prepayments were made for the purpose of maximizing the tax benefits and minimizing current pension expenses. "As a result of these prepayments, Duke has lowered its current and ongoing O&M expenses in a manner similar to a utility making capital investments" (id.).

Exh. DTE-1-3. The Department has historically granted the same ratemaking treatment to a company's Allowance for Funds Used During Construction ("AFUDC"). Under Department policy, AFUDC charges are accrued on construction work in progress prior to the capital investment being placed in service. AFUDC charges are then placed in rate base along with other construction costs once it is determined that the investment is used and useful. Milford Water Company, D.P.U. 84-135, at 12 (1985).

Under FAS accounting requirements, companies must accrue on its books, in advance, future pension obligations for its employees. Exh. KEDNE/JFB-1, at 30. The application of carrying charges as proposed in the adjustment mechanism would compensate the Company or its customers for the timing differences between the collection of revenues from customers and the payment of cash contributions into the funds by the Company. Exh. KEDNE/JFB-1, at 41.

Moreover, the record shows that these amounts are not captured in the working capital requirement. Tr. 25, at 3394. The Company testified that the contribution, or the cash outlay from Boston Gas for pensions in 2002, was $44 million; however, the O&M expense was $6 million in 2002. Id. at 3395. Thus, it is the $6 million expense, and not the actual cash payment of $44 million upon which cash working capital is based. Id. at 3396. As shown in Exhibit KEDNE/PJM-2, at 41, which derives the working-capital allowance, the working-capital allowance is based on O&M expense, which means that the calculation does not consider the $44 million of cash prepayment.

As described in the Company's Initial Brief, the Department has recognized that when there is a significant timing difference between a payment by a company and the receipt of revenues from customers (especially where prepayments are mandated by the

Department), it is appropriate to apply carrying charges. See, e.g., Fitchburg Gas and Electric Light Company, D.P.U. 1214, at 8; Boston Gas Company, D.P.U. 1100, at 19-25. The proposal, including the collection of carrying charges, violates no Department ratemaking policies, and should be approved.

4. Boston Gas Is Fully Funding its Pension/PBOP Plans in 2003.

The Attorney General asserts that the Company has told its investors that it has no plans to make any contributions to its employee retirement trust funds for the year 2003 (Attorney General RB at 29). This is an erroneous assertion that is contradicted by record evidence, as discussed above in Section VIII.B.1. Accordingly, the Attorney General's assertion should be rejected by the Department.

C. There Is No Basis to Exclude the Company's Sales Promotion Expense.

The Attorney General contends that the Department should disallow the Company's test-year sales promotion expenses and instead: (1) use a five-year average of sales promotion and advertising expense combined, or $7,691,288 (Attorney General RB at 33); and also (2) exclude $1,120,736 from the total sales promotion and advertising expense to reflect the percentage of electric conversions (id. at 34). However, the Attorney General bases this claim on a blatant misstatement (or misunderstanding) of the Department's precedent on the cost-benefit analysis, misrepresents the record and inaccurately calculates the costs used in the IRR calculation.

The Attorney General states that "the Company's arguments cannot avoid one crucial, inescapable fact – the Company failed to perform a separate cost-benefit analysis for marketing program expenses that show a net benefit to ratepayers" (Attorney General at 30). In support of this broad and sweeping claim, the Attorney General states the

single proposition that "the Department has rejected cost benefit analyses that merely provide total costs and expected margins" (id., citing Berkshire Gas Company, D.T.E. 01-56, at 67; Berkshire Gas Company, D.T.E. 01-56A at 16-17.). However, this is not the proposition that is established by the Berkshire findings.

In Berkshire, the Department disallowed $325,433 in promotional program costs stating that:

> [T]he Company did not perform a cost-effectiveness analysis to support recovery of the incentive program costs. Instead, Berkshire provided the total costs of the program and the subsequent expected margins. . . . Specifically, the evidence indicates that the cost of the program in the test year was $325,433 (i.e., $892 per customer acquired). . . . The record further shows that the annual net margin in the test year for the Company was $180,389 (i.e., $494 per customer). Based on this evidence, the Department finds the Company's marketing program does not provide net benefits to ratepayers.

D.T.E. 01-56, at 67. The Department then stated that:

> The Department notes that a more comprehensive analysis would include not only the cost of the rebates and free equipment, but the cost of adding customers on the system, i.e., the Company's marginal customer cost.

Id. at fn.20 (emphasis added). On reconsideration, Berkshire Gas argued that the Department failed to consider the annual net margins generated over the life of the investments and that, over a useful life of 30 years for each investment, net margins of at least $1,459,080 would be produced. D.T.E. 01-56-A at 15. By the company's calculation, it would generate a net margin of $1.5 million with a one-time cost of $190,000, resulting in an after-cost margin of $1.3 million. Id.

In its decision on reconsideration, the Department agreed that an appropriate cost/benefit analysis must account for the annual net margins generated over the life of a measure. Id. at 16-17. However, the Department found that Berkshire did not provide this analysis during the course of the proceeding, and therefore, rejected the company's

request for reconsideration on the issue. Id. at 17. In doing so, the Department noted that the conversion of customers from oil or electricity to gas requires the installation of a service drop and a meter for each customer. Id. at 17, fn.8. Therefore, the Department found that these are incremental costs that should have been considered in the evaluation of the marketing programs.[30] Id.

As a result, the Department's findings in the Berkshire case on this issue stand only for the proposition that marginal customer costs, i.e., the cost of installing the service drop and meter, must be included in the calculation of "total costs and expected margins." These findings do not stand for the proposition set forth by the Attorney General, which is that cost-benefit analyses that combine revenue-producing plant additions with sales promotion expense for the purpose of calculating an IRR will be rejected by the Department (Attorney General RB at 30). Nor do these findings in any way prescribe or dictate the details of a company's cost-benefit analysis. In fact, as discussed in the Company's initial brief, the requirement to include the marginal system investment associated with the program requires that the sales promotion program expense be incorporated into an IRR calculation for the revenue-producing investment.

The Attorney General posits a number of conflicting claims in this regard. First, the Attorney General claims that "the record does not contain evidence supporting the Company's claim that the sales promotion program and growth plant additions are

[30] The Department also noted that in view of the 10-year price-cap mechanism proposed by Berkshire, the inclusion of $325,433 in its test-year expense would result in an over-recovery of costs because this amount would be recovered every year over the life of the plan. D.T.E. 01-56-A. at 17, fn.7. As discussed below, the record shows that the Company's expense level will remain constant over the term of the PBR Plan. See, e.g., Exh. MOC-1-2, MOC-2-6, MOC-2-7; AG-1-17. Thus, the net benefits to customers calculated in the first year would be duplicated with the expenditures in the subsequent years to perpetuate the system-growth cycle is demonstrated by the Company's net benefit analysis.

linked" (Attorney General RB at 30). Then, the Attorney General claims that "there is no proof that the customers who installed new gas lines in 2002 would have not done so without the sales promotion program" (id.). As an initial matter, there is no Department precedent that requires the Company to demonstrate that customers would not convert to gas service in the absence of a marketing program, nor does the Attorney General cite to such a standard.

In addition, contrary to the Attorney General's unsupported assertions, the record demonstrates a direct link between the Company's sales promotion activities and expense levels and growth in residential and C&I load addition. For example, the record shows that, in 2002, the Company invested $41,927,374 in total mains and services and meters. Exh. DTE 4-28(a), at page 1. The record further shows that these investments are associated with incremental load resulting from oil-to-gas conversions, low-use upgrades, and other types of load additions. Exh. DTE-4-28(a), at page 2. The record shows that 91 percent of residential load additions, and 69 percent of commercial and industrial ("C&I") load additions, resulted solely from gas conversions, low-use upgrades and new construction, all of which are the target of the sales promotion program.[31] Exh. DTE-4-28; Exh. AG-20-1; Exh. AG-25-1; Exh. MOC-2-4; Exh. MOC-3-1.

In addition, the record shows a link between the Company's commencement of the free burner program in 2000 and the growth in margins associated with residential and C&I load additions. Exh. DTE-4-28 (attachments a through g); Exh. MOC-1-1. For

[31] The Company added total residential margins of $11,167,052 annually, of which $10,239,495, or 91 percent resulted from the combination of gas conversions, low-use upgrades and new construction. Exh. DTE-4-28(a), at page 2. Similarly, for commercial and industrial load the Company added total margins of $5,991,749 annually, of which $4,134,977, or 69 percent, related to the combination of gas conversions, low-use upgrades and new construction.

example, both residential and C&I load additions and the number of customers added have grown in direct proportion to the growth in the Company's sales promotion expense following the commencement of the free burner program as shown below:

Year	Annual Residential Margins Added (1)	Annual C&I Margins Added (2)	Total Annual Margins Added	Number of Customers (excl. electric) (3)	Sales Promotion Expense (4)
2000	$4,633,970	$6,269,291	$10,903,261	7,347	$7,015,195
2001	$4,954,639	$9,485,244	$14,439,883	7,820	$9,290,752
2002	$6,541,421	$8,913,648	$15,455,069	11,520	$11,547,007

(1) From Exh. DTE-4-28 (Attachments a through g);

(2) From Exh DTE-4-28 (Attachments a through g);

(3) From Exh. MOC-1-3, includes residential and C&I

(4) From Exh. AG-1-2 (DTE Annual Returns at page 47)

Accordingly, the record shows a direct correlation between growth in the level of sales promotion expense and the level of annual margins generated, which therefore-links the Company's revenue-producing investments to sales promotion expense.

Lastly, the Attorney General contends that the Company is wrong asserting that "customers benefit from the promotion expense during the PBR Plan" (Attorney General RB at 30). The Attorney General states that customers will upfront more than $70 million to the Company ($11.5 million x 6 years), during the PBR period "without seeing a dime of benefit" (id. at 31). The Attorney General goes on to say that the Company's "net present value analyses are incorrect in showing benefits to ratepayers" and that those "benefits flow to shareholders during the first six years" (id.). However, the Attorney General's statement misrepresents the Company's analysis and is inaccurate.

In its Initial Brief, the Company calculated the net present value to customers in the period 1997 through 2002, not in the period of the proposed PBR Plan (2002-2008)

(Company IB at 87).[32] These benefits will be locked into rates in this proceeding, because the increased volumes resulting from investments in the years prior to 2002 are included in calculating the revenue requirement. Similarly, the incentive-program costs recovered through rates during the PBR Plan period will inure to the benefit of customers in the next rate proceeding. The Attorney General's recommendation to disallow these costs is made in the interests of expediency and will only deprive customers of the benefits of growth over the long term. Therefore, the Attorney General's claims that the Company's statements are inaccurate and should be disregarded.

Next, the Attorney General contends that the Company's "stance" shows a willingness to sacrifice service quality for new load (Attorney General RB at 31). Again, this statement must be disregarded. There is no evidence on the record to support this contention, nor does the Attorney General cite to any such evidence. In fact, the record shows that the Company continues to be subject to the Department's comprehensive service-quality guidelines, and that the Company continues to meet or exceed those thresholds. Exh. AG-22-15; Tr. 21, at 2766-68.

Next the Attorney General claims that the Company has not shown that it included all appropriate costs in calculating the internal rates or return (Attorney General RB at 31). The Attorney General claims in this regard are nothing more than an attempt to confuse the issue. For the sake of clarity, the Company will address each of the Attorney General's claims in sequence:

(1) The record shows that the Company included $6,228,542 in sales promotion expenses in the calculation of the IRR for 2002. Exh. DTE-4-28(a); (see Attorney General RB at 31);

[32] Although the Attorney General does not cite the period he is referencing to, his calculation ($11.5 million x 6 years) can only refer to the period falling under the new PBR Plan, since the $11.5 million occurred only in 2002 (Attorney General at 30).

(2) The Company explained that the $5,908,818 presented in response to Exh. DTE-4-27 was in error (see Company IB at 85, fn.37) (re: Attorney General RB at 31);

(3) The Company explained that Exhibit AG-23-1 shows a breakdown of direct expenses of $7,428,258 and indirect expenses of $4,118,749 because the exhibit was prepared by Ms. Leary (and not Mr. McClellan) at the request of the Attorney General to demonstrate the cost allocation between the residential and C&I classes (Company IB at 84, fn.35) (re: Attorney General RB at 31);

(4) The Company presented a reconciliation of the "direct" amount listed in AG-23-1 of $7,428,258 to the $6,228,542 presented in Exhibit DTE-4-28 showing the amounts that were erroneously listed as "direct" in AG-23-1 (Company IB at 84, fn.35) (re: Attorney General RB at 31);

(5) In Exhibit MOC-1-14, the Company was asked to detail "any and all" of its "free equipment giveaway programs." The Company stated that during the test year there were 11,484 Massachusetts customers who qualified for the free equipment program and that the total amount expended on the program was $6,183,540. Exh. MOC-1-14. Thus, this amount represents the cost of the free burner program (and no other promotional expenses) for all Massachusetts customers, and therefore, only a portion of this cost would be allocated to Boston Gas. This figure is not a misstatement of the Company's total promotional expenses of $6,228,542 included in the 2002 IRR calculation in Exhibit DTE-4-28 (re: Attorney General RB at 31-32);

(6) In RR-AG-86, The record shows that the Attorney General asked the Company to produce the invoices that support the costs included in Activities Nos. 3272 and 3281 for the months of February and August 2002. Tr. 23, at 3159. The Attorney General did not request that the Company "itemize DTE Account 912 Activity 3272 expense for the free giveaway program for 2002," as he claims, nor did the Attorney General request that the Company "itemize indirect costs" (re: Attorney General RB at 32). The Attorney General is simply misstating the record;

(7) In addition, in responding to RR-AG-86, the Company stated that it does not track the purchase and delivery of individual pieces of free equipment within the KeySpan service area in Massachusetts. Therefore, the accounts payable listing that accompanied the listing showed payments for all three of KeySpan's Massachusetts LDCs. RR-AG-86. (re: Attorney General RB at 32);

(8) It is only coincidental that the accounts payable listing associated with the invoices for the free burners totals $11,504,844 (if it does), as claimed by

the Attorney General (Attorney General RB at 32). As stated in RR-AG-86(3), this is a listing of the payments to vendors for free equipment and not a breakdown of the approximately $11,547,007 million in promotional costs recorded in Account 912 in the test year. The Attorney General is simply attempting to confuse the record; and

(9) The record shows that the listing of burner equipment in RR-MOC-1 provides the "equipment distributor price" for each type of equipment (totaling $12,064,074). This is not the amount "paid to equipment distributors" as claimed by the Attorney General because these amounts are reduced for rebates and customer contributions, as shown in RR-MOC-1 (re: Attorney General RB at 32, fn.20). In fact, the total net cost of the free equipment for Massachusetts customers reported in RR-MOC-1 is also reported in Exhibit MOC-1-14 of $6,183,540 (discussed above) (re: Attorney General at 32).

Despite the Attorney General's claims, the record is clear that, in the test year, the Company incurred a total of $13,667,512[33] associated with promotional sales and advertising expenses (booked to DTE Accounts 912 and 913, respectively). Of this amount, the Company booked $2,120,505 to Account 913 as advertising expense and $11,547,007 to Account 912 as promotional sales expense. See, Exh. AG-1-2B(8)(a) at pages 47, 80b. The amounts booked to these accounts include both direct and indirect expenses. Direct expenses are the costs the Company incurs in relation to the specific sales promotion or advertising activity it has undertaken (for example invoiced charges from advertising agencies to develop and publish specific advertisements and rebates associated with the Company's sales promotion activities.) Indirect expenses are associated with the salaries, benefits and overheads relating to various Company employees whose responsibilities include overseeing the Company's sales promotion and advertising activities.

[33] In its initial filing, the Company identified $641,204 associated with non-allowable corporate image advertising expenses, which were deducted from the cost of service. As a result, the Company is seeking recovery of total direct and indirect sales promotion and advertising expenses of $13,026,308 See Exhs. MOC-1-1, MOC-1-2(a), AG-23-1, KEDNE/PJM-2 [rev.2], at page 24.

The record is also clear that, of the $11,547,007 of promotional sales expenses booked to Account 912 in the test year, $6,228,542 is associated with direct sales promotion activities and $5,318,465 is indirect expense related primarily to the administrative and general expenses incurred for payroll and office administration of the Company's entire sales force.[34] Exh. AG-1-2B(8)(a) at page 47; Exh. AG 23-1, at page 1 of 4; Exh. AG-13-19. Moreover, the record shows that the IRR for revenue-producing investment was calculated for 2002 to include direct and indirect construction costs, as well as the direct costs of the Company's sales promotional programs (i.e., $6,228,542).[35] Exh. KEDNE/PJM-9; Exh. DTE 4-27 and Exh. DTE-4-28. The various figures quoted by the Attorney General, including the $16.8 million that he contends should be included in the IRR calculation, are presented only to confuse and distort the record and his claims, as well as his strategy, should be rejected by the Department.

The Attorney General next claims that the Company has not demonstrated that its test year sales expenses are representative of the level of costs that it will incur during the

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[34] This breakdown differs from the breakdown presented in Exhibit AG-23-1, which shows direct expenses of $7,428,258 and indirect expenses of $4,118,749, because that exhibit was prepared to demonstrate cost allocation between the residential and commercial classes, rather than to detail direct versus indirect costs. The direct amount of $7,428,258 includes corporate administrative costs of $742,434, a reduction for vendor credits of $400,000, and other credits of $56,650, which must be removed from the direct sales-promotion expense category for purposes of performing a cost-benefit analysis. With these amounts removed, the total incentive program costs are $6,228,542, as shown in the IRR calculation presented in Exh, DTE-4-28.

[35] Although the Department has never required IRRs to be calculated to include the direct and indirect costs of construction, as well as the direct and indirect costs of the sales promotional program, the inclusion of the $5,318,465 in indirect sale-promotion expense would reduce the IRR only by a small fraction. Exh. DTE-4-28(a). This is because the total direct and indirect expense included in the IRR calculation is $48,155,916, and therefore, the affect of including indirect expenses of $5,318,465 would be to increase the system-growth investment amount by only 10 percent. Id. Therefore, the inclusion of this small amount of additional expense would have the effect of reducing the IRR of 18.83 percent only slightly, well above the weighted cost of capital threshold of 9.38 percent. Notably, the Attorney General claims that the IRR would be decreased with the inclusion of these costs, but does not claim that the IRR would fall below the threshold of 9.38 percent (Attorney General RB at 32; Attorney General IB at 50-51).

period that rates will be in effect (Attorney General RB at 32, citing D.T.E. 98-51, at 39.) There are two problems with the Attorney General's claims in this regard: (1) he misapplies the Department's standard regarding the representativeness of test-year costs; and (2) he misconstrues the Company's burden of proof on this issue. First, after stating that the Company has not demonstrated that its "test year sales expenses are representative of the level of costs that it will incur during the period that rates are in effect," (emphasis added) the Attorney General contends that the Company's test year sales promotional costs "skyrocketed past the amount of those costs in the previous years" (Attorney General RB at 32-33). The Attorney General then lists the costs incurred by the Company in years prior to the test year, and then contends that the "dramatic increase" in sales expense "demonstrates" the test year is not representative and that the amounts recovered through rates "must be an average amount" (Attorney General RB at 33). However, the Attorney General has clearly misapplied the Department's standard, and therefore, his proposal to use an average of historical levels of expenses ($7,691,288) must be rejected as unfounded by the record and inconsistent with Department precedent.

Under Department precedent, test year expenses that occur on an annual basis are eligible for full inclusion in the cost of service, unless the record supports a finding that the level of the expense in the test year is "abnormal." FG&E, D.P.U. 1270/1414, at 33 (1983). This means that the presumption is that the Company's test year sales promotion expense level is "normal," unless evidence is presented to rebut that presumption and to demonstrate that they are abnormal. However, the Attorney General focuses only on prior years to show that the amount spent in 2002 has "dramatically increased" by

comparison (Attorney General RB at 33). This conclusion is not sufficient to rebut the presumption that the Company's test-year level is representative. In fact, the Attorney General ignores record evidence showing that the Company intends to maintain this commitment to its sales promotion activities going forward. See, e.g., Exh. MOC-1-2; Exh. MOC-2-6 (stating "it is the Company's intention to continue to maintain its trade ally program in the future"); Exh. MOC-2-7 ("the Company intends to continue its trade ally programs and . . . the budget for the trade ally programs over the next four years approximates the amount proposed for inclusion in rates in this case"); Exh. MOC-2-10 (stating "the Company's budget for promotional expenses over the next four years approximates the amount proposed for inclusion in rates in this case); Exh. AG-1-17 (showing revenue-producing investment to be maintained and increased over the PBR Plan term). As noted below, the Attorney General has not disputed these representations.

In that regard, the Attorney General inaccurately states that the Company has "not shown that its test year sales expenses are representative of the level of costs it will incur during the [PBR Plan]" (Attorney General RB at 32). As stated above, under Department precedent, the presumption is that the test-year level of expense is representative.[36] The Attorney General never inquired about or challenged the Company's statements that its spending levels would be maintained throughout the five-year period of the PBR Plan. In fact, the Attorney General does not in any way dispute the Company's statements about the going forward expense; he only claims that the amount incurred in the test year is

[36] The Department has also stated that companies may include in their cost of service a representative level of recurring, non-extraordinary expenses, as long as these expenses are reasonable. D.T.E. 98-51, at 39. The Attorney General does not make any argument that the costs are not reasonable, nor would such a finding be supported by the record. The "reasonableness" of the Company's expense is demonstrated on this record by the IRR calculation, which calculates the net benefit that is received by customers as a result of system growth. See e.g., Exh. DTE 4-28.

non-representative because it is more than the amount expended in the past. Accordingly, his contention that the test-year amount should be reduced to reflect an average of the years prior to the test year is unsupported by the record and inconsistent with Department precedent, and therefore, should be rejected by the Department.

Lastly, the Attorney General claims that the Department should reduce the "recoverable amount" of sales promotion expense by $1,120,736 to reflect the percentage of electric conversions (Attorney General RB at 33). This adjustment is completely inappropriate because (1) the Department has only ever applied this principle to advertising expense, and certainly, has never applied it to administrative and general expense, which is included in the Company's total advertising and promotional expense amount; and (2). none of the Company's sales promotion programs are available to customers converting from electric service. Exh. MOC-2-4. The central objective of the promotional programs is to convert customers who are low-use (i..e., currently non-heating customers) or located on the Company's mains, but currently taking oil service rather than gas service (i.e., new gas conversion customers). Therefore, although the record shows that approximately 1,034 customers converted from electric to gas service in the test year, none of these customers were eligible for offers under the Company's promotional programs. Exh. MOC-1-3.

The Attorney General offers no legal or factual support for his assertion that these costs should be adjusted to account for an "electric conversion factor," and therefore his claim should be rejected. Moreover, the Attorney General's calculation should be rejected because it is inaccurate. Specifically, the calculation has (1) double-counted expenses included in the DTE Accounts 912 and 913 and (2) double-counted post-test

year exclusions. The Attorney General argues for an 8.2 percent reduction in sales promotional expenses totaling $13,667,512, which is the total amount of sales promotional and advertising expense booked to the DTE Accounts 912 and 913. Exh. MOC-1-1. However, the record shows that the Company has already made a post-test year adjustment to remove $641,204 associated with non-allowable corporate image advertising in Account 913, which reduces the test year amount to $13,026,308. Exhs. MOC-1-1; MOC-1-2(a), AG-23-1, KEDNE/PJM-2 [rev.2], at page 24; see also, Company IB at 83, fn.34.

In addition, the Attorney General argues for the elimination of $670,000 in advertising expenses booked to Account 913 based, in part, on the argument that the ads were targeted to electric customers (Attorney General RB at 34-36). Accordingly, in arguing for a 8.2 percent reduction in the total expenses booked in Accounts 912 and 913 ($13,667,512), and a $670,000 reduction in advertising expenses booked in Account 913, the Attorney General is double-counting the effect of reducing expenses by the ratio of electric conversions. Lastly, the advertising and promotional sales expense recorded in DTE Accounts 912 and 913 include administrative and general expense that must be removed from the calculation. Therefore, even if the Department were to apply the Attorney General's proposed "electric conversion factor," which is not warranted by the record or Department precedent, the Department must correct the Attorney General's calculation.

D. The Department Should Reject the Attorney General's Mischaracterization of the Company's Evidence and Department Precedent Regarding Advertising Expenses and Find that Such Expenses Are Appropriate for Recovery Through Rates

The Attorney General's Reply Brief maintains three claims regarding the Company's advertising expenses, which should be rejected by the Department: (1) that the Company has not demonstrated that the costs reflected on Exh. AG 25-1(4), (5) and (6) are related to ads that actually ran (Attorney General RB at 34); (2) that the Department should deny the Company recovery of expenses relating to four advertisements that the Attorney General claims are "illegible" (Attorney General RB at 35); and (3) that the Department should deny the Company recovery of the majority of costs relating to promotional advertisements (Attorney General RB at 34-35). The Company will address these claims in sequence:

1. <u>"Unused" Radio Advertisement</u>

The Attorney General contends that the Company's invoices are insufficient to document the purpose of the expense and that, as a result, the Department should deny recovery of approximately $90,000 of costs related to the following invoices: Exh. AG-25-1(4), (5) and (6) (Attorney General RB at 34). The Attorney General requests that the Department disallow this expense because the invoices show only that the Company paid the advertisement agencies to develop a marketing campaign, and that the invoices are related to four advertisements, one of which (Value Snobs) did not run. (Attorney General RB at 34). Although the Attorney General fails to mention it, the Company has, in fact, provided record evidence detailing the airtime charges and correlating those charges to the ads and invoices in question. This record evidence is as follows:

(1) Exh. AG-25-5 states the Earle Palmer Brown purchases the media for radio and television advertisements.

(2) In RR-AG-54-B, the Company noted that KeySpan typically purchases **"blocks" of airtime** over a multi-week period of an advertising campaign.

(3) In RR-AG-54-B, the Company stated that it typically purchases blocks of airtime for an advertising campaign and then is credited back for any time that is not used.

(4) In RR-AG-54-B, the Company provided the 2002 Advertising Media Plan detailing **all blocks of media time purchased in 2002**. This exhibit contained detailed backup documentation on the number of ads and airtime purchased.

(5) The record shows that the Winter 2002 campaign included the Belching Baby ad, the New Boiler ad and the Rubber Duckie ad **and that these ads ran in the months** of February through April 2002. RR-AG-54-B at 2.

(6) The record further shows that the **Value Snobs ad did not run**. Tr. 14 at 1807.

(7) **Invoice AG-25-1 (4)** is from Earle Palmer Brown with total charges to Boston Gas of $7,959 (out of a total invoiced amount of $11,704). On the invoice it states "Cape Cod Radio – Feb-Apr. 2002." The record shows that the invoice is related to the Winter 2002 advertising campaign. Exh. AG-25-1(4); RR-AG-54-B. "Cape Cod Spot Radio" is listed under the "Broadcast" category in the 2002 Advertising Media Plan in RR-AG-54-B.

(8) **Invoice AG-25-1(5)** is from is from Earle Palmer Brown with total charges to Boston Gas of $164,404 (out of a total invoiced amount of $241,771). On the invoice it states "Boston Spot Radio – Feb-Apr. 2002." The record shows that the invoice is related to the Winter 2002 advertising campaign. Exh. AG-25-1(4); RR-AG-54-B. "Boston Spot Radio" is listed under the "Broadcast" category in the 2002 Advertising Media Plan in RR-AG-54-B.

(9) **Invoice AG-25-1(6)** is from is from Earle Palmer Brown with total charges to Boston Gas of $198,290 (out of a total invoiced amount of $291,603). On the invoice it states "Boston Spot TV – Feb-Apr. 2002." The record shows that the invoice is related to the Winter 2002 advertising campaign. Exh. AG-25-1(4); RR-AG-54-B. "Boston Spot TV" is listed under the "Broadcast" category in the 2001 Advertising Media Plan in RR-AG-54-B (the charges applied to 2001, but were billed and paid in 2002). RR-AG-54-B.

Accordingly, the Attorney Generals' claim must be rejected because the record shows that (1) the Company purchases airtime in blocks for multi-week periods of an advertising campaign; (2) the invoices were for the purchase of airtime for the Winter 2002 advertising campaign, and not just payments to the "advertisement agencies to develop a marketing campaign" (Exh. AG-25-1; Exh. AG-25-5; RR-AG-54-B); and (3) the Value Snob ad did not run, although it was developed as part of the Winter 2002 campaign (Exh. AG-25-1; RR-AG-54-B; Tr. 7, at 1807).

Moreover, there is no basis to exclude 25 percent of the costs associated with these three ads as suggested by the Attorney General. The fact that the invoice itself does not provide the level of detail that the Attorney General claims is needed, does not suffice as a basis to exclude the costs. The Company has met its burden to demonstrate on the record that these invoices represent the cost of airtime purchased by the Company as part of its promotional advertising campaigns.

2. Illegible Invoices/Advertisements

In his reply brief, the Attorney General reiterates his contention that the Department should exclude invoices or the cost of advertisements totaling approximately $48,000, based on claims that such invoices or advertisements were not provided by the Company or were illegible (Attorney General RB at 35). The Company disputes the Attorney General's contention regarding four of the invoices/advertisements cited by the Attorney General as either "missing" or "illegible" (Exh. AG-20-1(36), Exh. AG-25-1(53), (129) and (137), totaling approximately $39,000. Although the Company agrees with the Attorney General that the final determination regarding the legibility of these advertisements/invoices must be made by the Department, it should be noted that the Attorney General never challenged this invoices during the proceeding, despite the

significant amount of time spent on reviewing the Company's advertising records. As a result, the Company is now denied the opportunity to clarify the invoices that the Attorney General now claims are illegible. Therefore, the Company reiterates that, based on the clarity of these advertisements/invoices and their presence on the record, the Department should disregard the claims of the Attorney General and allow their respective costs to be included in the Company's cost of service.

3. Advertisements Encouraging the Use of Natural Gas

With respect to "conversion and promotion" advertisements, the Attorney General contends that the Company is seeking to recover approximately $230,000 of costs associated with advertisements that "encourage customers to choose natural gas over electricity" (Attorney General RB at 35). However, even if the advertisements are "multipurpose," i.e., having appeal to users of regulated and unregulated fuels, the Attorney General disregards the Department's precedent that allows recovery of costs associated with multi-purpose advertisements on a pro rata basis. Bay State Gas Company, D.P.U. 92-111, at 187-188 (1992).

As noted by the Company in its Initial Brief, the Department's policy on the recovery of promotional expenses has evolved over time and stems from the provisions of G.L. c. 164, § 33A, which state that:

> No gas or electric company may recover from its ratepayers any direct or indirect expenditures for promotional or political advertising, except where such advertising informs consumers of an stimulates the use of products or services which are subject to direct competition from products or services of entities not regulated by the Department.

To avoid the ban on promotional advertising under G.L. c. 164, § 33A, a company must show that its advertising qualifies for one of the stated exemptions, e.g., that it competes

with fuel oil. Bay State D.P.U. 92-111, at 192; Boston Gas Company, D.P.U. 88-67, at 112 (1988). Therefore, under Department precedent, general promotional advertising aimed at a non-regulated energy source (e.g., oil), or that leaves the reader/listener with the impression that a non-regulated energy source is the target of the advertisement may be recovered from ratepayers.[37] The Berkshire Gas Company, D.P.U. 90-121, at 133 (1990); D.P.U. 92-111, at 186. If the advertisement meets this condition, it will be included in cost of service, subject to certain constraints. For example, the Department has apportioned costs between ratepayers and shareholders for multi-purpose advertisements (those directed at both regulated and non-regulated energy users). D.P.U. 92-111, at 187-188 (1992). In the past, the Department has allocated the costs between between ratepayers and shareholders based on the percentage of consumption associated with the end-users targeted in the ad. Id.

Therefore, with regard to the costs of each of the promotional advertisements cited by the Attorney General for removal from the Company's test year expenses, the record shows that a majority of the costs are recoverable. The associated advertisements/invoices are multi-purpose and at least some portion of the advertisement/invoices referenced by the Attorney General are targeted toward non-regulated energy users or customers to that the Company is attempting to encourage to use natural gas to heat items that the customer may not currently be heating, e.g., pools, spas. Accordingly, the Company is entitled to an apportionment of the costs, rather than outright exclusion as suggested by the Attorney General.

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[37] The Department has stated that it would be an unnecessarily narrow interpretation of G.L. c. 164, § 33A to require that the company specifically name the unregulated fuel. D.P.U. 92-111, at 186.

For example, with respect to invoices cited by the Attorney General that were provided to the Department in response to Exh. AG-20-1, nine of the eleven invoices promote the use of natural gas to heat pools and/or fireplaces.[38] In addition, with respect to advertisements cited by the Attorney General that were provided to the Department in response to AG-25-1, over half of the advertisements were at least partially aimed at promoting similar uses for natural gas.[39] However, with respect to the Company's advertising expenses promoting the use of gas-heated fireplaces, the Company is competing directly with providers of wood and pellet stoves, neither of which are regulated fuels. Similarly, advertising expenses relating to the use of gas-heaters for swimming pools and spas are not aimed at converting users of a regulated fuel, but rather are designed to encourage customers to heat these items in the first place. Tr. 17, at 2203-2205. Therefore, these considerations should be factored into the evaluation of allowable advertising expense.

With respect to apportionment of advertising expenses, the record shows that approximately 91 percent of the customer conversions during 2002 were from customers that used oil, rather than electricity. Exh. MOC-1-3. This means that 91 percent of the Company's customers who have converted to natural gas have converted from oil-based home and water heating systems. Therefore, in addition to ads promoting the use of natural gas for fireplace and pool/spa heaters, this statistic supports a finding by the Department to allow the Company to recover the costs of advertisements relating to the promotion of natural gas for heating water. Accordingly, the Company should be

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38 Exh. AG-20-1 (6), (15), (18), (29)., (40), (45), (52), (56) and (60).

39 Exhs. AG-25-1 (17), (20), (35), (48), (50), (56), (60), (62), (65), (88), (99), (115), (132), (134), and (136).

allowed to recover at least 91 percent of the costs of those multi-purpose advertisements where the product being promoted competes against both a regulated and non-regulated product.

The Attorney General also mischaracterized three of the Company's multi-purpose advertisements as relating solely for "donations, renovation projects and business cards" (Attorney General RB at 35). On the contrary, the Company demonstrated that, with respect to advertisements submitted in response to Exh. AG-25-1 (63, 111 and 112), the Old North Church and Winthrop Fire Department stories related specifically to the Company's successful conversion of these entities to natural gas heat. Accordingly, at least a portion of the costs of those advertisements are appropriate for recovery as a test year expense.

Similarly, the Department should allow, at least, a pro rata share of the costs relating to the invoices cited by the Attorney General as being "multipurpose" in the Company's test year expenses. Specifically, the Department should adopt the following methodology for including/excluding costs in rates:

Advertising Related Expenses for Invoices Provided in Exh. AG-20-1						
Invoice	**Date**	**Vendor**	**Invoice Amount**	**Allocated Amount**	**Targeted at Non-Regulated-Fuels or Operable Without Heat (1)**	**Amount Included in Rates[40]**
1	8/27/02	The SKM Group	$970	$660	Oil heater (10%)	$66
6	2/20/02	EY Productions	$1,127	$766	Pool heater/Fireplace	$697
15	3/13/02	EY Productions	$591	$402	Pool heater/Fireplace	$366
18	4/11/02	EY Productions	$12,700	$864	Pool heater/Fireplace	$786
29	5/4/02	EY Productions	$419	$285	Pool heater/Fireplace	$259
35	5/16/02	Bruce R. Thaler	$167	$113	Oil heater/Fireplace/Pool Heater/Spa Heater (50%)	$51
40	6/13/02	EY Productions	$205	$139	Pool heater/Fireplace	$126
45	7/5/02	EY Productions	$252	$171	Pool heater/Fireplace	$156
52	8/14/02	EY Productions	$473	$473	Pool heater/Fireplace	$430
56	9/10/02	EY Productions	$447	$447	Pool heater/Fireplace	$407
60	11/7/02	EY Productions	$345	$345	Pool heater/Fireplace	$314

(1) Allocated using 91 percent factor, unless noted.

[40] Where the product that the Company is advertising competes against products from both regulated and non-regulated industries, the Company has apportioned 91 percent of the costs to the cost of service. Where a product in a multi-purpose advertisement/invoice only competes with a product fueled by electricity, the Company has eliminated that portion of the advertisement/invoice promoting the use of a natural gas-fueled product over the electricity-fueled product. Where an advertisement includes information promoting a product that competes against both regulated and non-regulated products, the Company multiplied 91% times the cost of that portion of the multi-purpose advertisement/invoice that is recoverable. However, where the product in a multi-purpose advertisement is solely competing against a non-regulated product, e.g., an oil heater, the Company has not applied the 91% conversion factor to the expense, but rather has multiplied the percentage of the ad space dedicated to promoting gas over a non-regulated product times the apportioned cost of the ad.

Advertising to Promote Conversion From Oil/Propane to Natural Gas Provided in Response to Exh. AG-25-1						
Invoice	**Date**	**Vendor**	**Invoice Amount**	**Allocated Amount**	**Targeted at Non-Regulated-Fuels or Operable Without Heat**	**Amount Recoverable**
17	2/13/02	JP Graphics	$175	$119	Grills, fireplace, spas (20% each)	$65 ((119 x .60) x .91)
20	2/14/02	JP Graphics	$2,650	$1,802	Pool heater	$1,640 (1,802 x .91)
33	3/15/02	Earle Palmer Brown	$5,476	$3,724	Oil heater (33%)	$1,229 (3,724 x .33)
34	3/20/02	Earle Palmer Brown	$106,182	$72,204	Oil heater (75%)	$54,153
35	3/20/02	JP Graphics	$1,000	$680	Pool heater	$619
44	3/29/02	Earle Palmer Brown	$56,020	$38,094	Oil Heater (50%)	$19,047
46	4/1/02	RFS Communications	$3,255	$2,213	Oil Heater (50%)	$1,107
48	4/6/02	Crowley Design	$680	$462	Grilles, fireplace, spas (20% each)	$252
50	4/10/02	Flagship Press Inc.	$763	$519	Pool heater (50%); Grilles, fireplace, spas (10% each)	$378
56	4/13/02	Crowley Design	$145	$99	Pool heater	$90
60	4/18/02	Flagship Press Inc.	$411	$280	Grills, fireplace, spas (20% each)	$153
62	4/22/02	Flagship Press Inc.	$654	$445	Pool heater	$405
63	4/24/02	Earle Palmer Brown	$54,650	$37,162	Oil heater (25%)	$9,291
65	5/7/02	EY Productions	$1,230	$836	Fireplace, pool heater (33% each)	$507
67	5/10/02	EY Productions	$287	$195	Oil Heater (50%)	$98
80	6/27/02	EY Productions	$132	$90	Oil Heater (50%)	$45
88	7/9/02	Flagship Press Inc.	$611	$415	Pool heater	$378
99	8/13/02	Crowley Design	$93	$63	Grilles, fireplace, spas (20% each)	$34
111	9/6/02	Earle Palmer Browne	$40,730	$27, 696	Oil heater (25%)	$6,924
112	9/6/02	Earle Palmer Browne	$154,569	$105,107	Oil heater (25%)	$26,277
114	9/18/02	JP Graphics	$865	$588	N/A	0
115	9/19/02	Flagship Press Inc.	$8,780	$5,970	Fireplace (50%)	$2,985
124	10/26/02	EY Productions	$181	$123	Oil Heater (50%)	$62
132	11/14/ 02	EY Productions	$428	$291	Oil Heater (90%); water heating (5%)	275 (291 x .9) + ((291 x .05) x .91)
134	11/15/02	EY Productions	$1,143	$777	Oil Heater (90%); Water heating (5%)	734
136	3/30/03	Crowley Design	766	521	Pool heater	474

Accordingly, the Department should approve the Company's recovery of at least $235,775 ($3,658 associated with Exh. AG-20-1, plus $232,117 associated with Exh. AG-25-1) relating to advertisements promoting natural gas over products that are fueled by non-regulated energy sources.

E. The Lease Expense for the Waltham Facility Meets the Department's Standard for Inclusion in Rates.

The Attorney General contends that the Department should remove from the Company's test year expenses the "incremental increase" in property lease expense associated with the Waltham lease, or $1,637,000 (Attorney General RB at 36). As with other cost-of-service items, the Attorney General makes various claims, none of which provide a basis for excluding the cost of the Company's primary workspace. The record shows that (1) the Company has included the cost of 113,000 square feet of office space in Waltham in the cost of service; and (2) that the Company is currently occupying 113,000 square feet of that space. Exh. KEDNE/PJM-2 [supp.] at 66-73; Exh. DTE-2-2; Tr. 2 at 161-162. The record also shows that the Company was able to take advantage of current market conditions by entering into a 20-year lease at approximately $17 per square foot. Id. The Attorney General does not dispute these facts.

Instead, the Attorney General contends that the lease expense should be disallowed because the Company is renting more space, using some of the space for non-Company purposes and to house non-company employees (id. at 37). Second, the Attorney General claims that the Company sublet some of its space to a non-regulated entity and then did not credit the sublease revenues to ratepayers (id.). Third, the Attorney General claims that the Company has assigned a value of zero to the Year 1 cost

instead of annualizing the lease expense, which (according to the Attorney General) would raise the Year 1 cost to over $1.5 million (id.). Lastly, the Attorney General claims that there is no evidence as to the efficiency gains, cost containment or ratepayer benefits (id. at 37-38). None of these claims, even if true, are a sufficient basis to support the exclusion of these lease expenses from the cost of service.

First, the Attorney General claims that the Company's per-square foot analysis is "misleading and inappropriate" because "the Company is renting more space, and using some of the space for non-Company purposes and to house non-Company employees" is contradicted by the record (Attorney General RB at 37). However, the Attorney General overlooks record evidence showing that the Company is occupying the 113,000 sq. feet of space that is included in the cost of service and that leasing this space has enabled the Company to bring its employees together for greater efficiency. Exh. DTE-2-2; Tr. 8 at 910. The Attorney General does not contest that the space is housing the Company's operations, nor does the Attorney General contend that the Company could have retained the necessary space at a rate lower than $17/sq. foot. The fact that the Company is using some of the space for non-Company purposes or to "house non-Company employees" has no bearing on the cost analysis.

Second, the Company has no burden to show that every square foot of Waltham space will be dedicated for Company purposes, as long as the Company has adjusted the costs included in the cost of service accordingly. Exh. KEDNE/PJM-2 [supp.], at 0068-0074; Exh. DTE-2-2. With regard to the sublease of Waltham space to a non-affiliated entity, the Company is subleasing only 2,000 of its 113,000 square feet of space (or approximately 1.7 percent) at Waltham to a non-Company entity, Energy Credit Union

(Tr. 2, at 164). This miniscule allocation of space to a non-Company entity in no way negatively affects the economics of the arrangement for the Company.

Lastly, the Attorney General claims that the Company has assigned a value of zero to the Year 1 cost instead of annualizing the lease expense, which (according to the Attorney General) would raise the Year 1 cost to over $1.5 million (id.). This statement is inaccurate and disregards accepted accounting principles. In fact, the record shows that the Company negotiated a free year and that the benefit of this "free year" was amortized over the 20-year term of the lease, which would have the effect of reducing the lease expense for the subsequent 19 years. Exh. DTE-2-2; Tr. 2, at 157, 161-162; Tr. 8 at 910. The record also shows that, this calculation is consistent with generally accepted accounting principles. Tr. 2, at 157.

Accordingly, the record demonstrates that the Company's inclusion of the property leases is reasonable, appropriate and consistent with Department precedent. Therefore, the Department should reject the Attorney General's claims regarding lease expense.

F. There Is No Basis to Exclude Proposed Merit and Incentive Increases for Non-Union Employees

In his Reply Brief, the Attorney General's reiterates his argument that the Company's merit, incentive and wage increases for non-union employees should be excluded from the Company's test year expenses (Attorney General RB at 38). The Company provided a comprehensive rebuttal to the Attorney General's contentions in its Initial Brief (at 105-117) and will not repeat the entirety of its arguments here. However, the Company will address two points:

First, the Attorney General insists, without support, that the Company's wage increases as compared to the Company's average total compensation, should be compared to the "local gas industry average" in order to determine the reasonableness of such wage increases (id.). However, the Department's standard is that increases for non-union salaries and wages will be allowed when the utility is able to demonstrate that the increases are reasonable and in line with the salaries and wages of *the employees at similarly situated companies that compete for skilled employees*. See The Berkshire Gas Company, D.T.E. 01-56, at 54 (2002); Massachusetts Electric Company, D.P.U. 92-78, at 25-26; Bay State Gas Company, D.P.U. 92-111, at 102-103. As a result, the Department's standard is broader than the interpretation relied on by the Attorney General.

In fact, the Department has previously allowed utilities to compare their wage levels to other regulated and non-regulated companies that compete for the same employees as the utility performing the comparison, whether or not such utility companies sell the same commodity as the petitioning utility. See, e.g., D.T.E. 01-56, at 57; D.T.E. 02-24/25, at 95. The standard applied by the Department properly recognizes that the skill levels of utility employees are very comparable, particularly at the management level. The Attorney General has failed to provide either evidence or legal precedent to support his contention that the Department should analyze the Company's total compensation only in the context of the limited comparison group of the "local gas industry." Accordingly, the Department should reject the Attorney General's argument regarding the reasonableness of the Company's total compensation.

Second, the Department should reject the Attorney General's contentions regarding the efficiency of the Company's employees. The cost study presented by Mr. Kaufmann as Exh. KEDNE/LRK-3 demonstrates that the Company is an above-average cost performer. Moreover, the fact that the Company's employee compensation levels total approximately 66 percent of its total O&M expense levels demonstrates that, although the Company's labor costs are a significant cost driver, the level of labor costs does not hinder the Company's overall efficiency. Exh. KEDNE/JFB-1, at 8-9; Exh. KEDNE/PJM-2 [supp.], at 16-17. Accordingly, the fact that the Company is a superior cost performer supports the Company's contention that its employee compensation is reasonable.

Third, the Department should reject the Attorney General's contentions regarding the Company's data and methodology (Attorney General RB at 39-40). The Company has presented several studies to the Department comparing the Company's non-union employee compensation to that of both regulated and general industry companies, each of which demonstrate that the Company's non-union wages are at levels consistent with those offered by the comparison companies (see, e.g., Exh. KEDNE/JCO-9; Exh. KEDNE/JCO-10; Exh. AG-10-1 **CONFIDENTIAL**; Exh. AG-10-8 **CONFIDENTIAL**). Accordingly, the Department should reject the Attorney General's unsupported claims and allow the Company's non-union merit pay, incentive pay and wage increases to be included in its test year cost of service.

IX. COST OF CAPITAL

A. The Attorney General's Proposed Capital Structure Should Be Rejected.

The Attorney General continues to argue for a capital structure that includes the impact of the merger between KeySpan and Eastern Enterprises (Attorney General RB at 41-42; Attorney General IB at 77). However, there is no dispute that the capital structure on the books of Boston Gas includes approximately $650 million of debt and $140 million of equity directly associated with the merger, and that eliminating these merger-related entries would result in a capital structure that is 32.01 percent long-term debt, 1.88 percent preferred stock, and 66.11 percent equity. Exh. KEDNE/PJM-1, at 36. As described in sworn testimony and summarized in the Company's Initial Brief, this merger-adjusted capital structure results in a high equity ratio that is atypical for utility ratemaking purposes (Company IB at 125). Consistent with Department precedent (and compatible with the capital structures of the Barometer Group and the expectations of rating agencies), the Company has proposed to impute a capital structure that limits the equity component to 50 percent (id. at 125-126, citing Exh. KEDNE/PRM-1; Exh. AG-14-10).

Although it is inconsistent with Department precedent, the Attorney General nonetheless insists on imposing a 59 percent debt ratio, which is inflated by the impact of the KeySpan/Eastern merger. The Attorney General contends that the "marketplace" has determined that a 59 percent debt ratio is reasonable, and that the Department should do likewise (Attorney General RB at 41-42). However, the ratios associated with the Attorney General's proposed capital structure include an amount of capitalization totaling $1,447,903,970. Exh. KEDNE/PJM-2, at 36. Yet, the Company's rate base is only

$626,935,813. Exh. KEDNE/PJM-2, at 1. The difference being $820,968,157 relating principally to entries associated with the merger. The "marketplace" acceptance of the debt ratio referenced by the Attorney General also includes the higher rate base associated with the merger goodwill. If the Attorney General's capital structure proposal were to be accepted, the Department would also need to increase the Company's rate base to approximately $1.448 billion.

The Company is not requesting the goodwill associated with the KeySpan merger be recovered in rates, and is therefore requesting that the impact of the merger be eliminated from both rate base and capital structure. The reversal of these merger-related entries leaves an unrepresentative capital structure, and, consistent with Department precedent, the Department requests that the Department apply an imputed capital structure with a 50 percent equity ratio.

B. The Company's Proposed Return on Equity Is Fair and Reasonable.

The Attorney General makes three arguments in his reply brief regarding the calculation of the cost of common equity: (1) that Boston Gas is less risky than the Barometer Group; (2) that a 4 percent DCF growth rate should be applied in the discounted cash flow ("DCF") analysis; and (3) that the most recent six months of dividend yields should be used in the DCF analysis (Attorney General RB at 42-46). As described below, none of these arguments has merit.

On the issue of the relative risk between Boston Gas and the Barometer Group, the Attorney General speculates that individually computed coefficients of variation, when averaged together, would have yielded an average measure of variability that indicates more risk for the Barometer Group than for Boston Gas (Attorney General RB

at 42-43). Using evidence on the record, and performing standard statistical calculations, the coefficients of variation for returns for the Barometer Group are as follows:

Company	Standard Deviation[41]	Average[42]	Coefficient of Variation[43]
AGL Resources	**1.1%**	**12.3%**	**0.089**
Atmos	**4.0%**	**10.2%**	**0.392**
New Jersey Resources	**0.5%**	**15.1%**	**0.033**
NICOR	**5.2%**	**15.0%**	**0.347**
Peoples	**1.3%**	**12.2%**	**0.107**
Piedmont	**0.7%**	**12.8%**	**0.055**
South Jersey Industries	**2.0%**	**11.3%**	**0.177**
WGL	**1.4%**	**11.7%**	**0.120**
Average			**0.165**

These values are calculated from the individual company analysis presented in Exhibit AG-5-1(a). The Boston Gas coefficient of variations is 0.246. Exh. KEDNE/PRM-1, at 21. This analysis shows that the Attorney General's criticisms about the statistical analysis presented by Mr. Moul are incorrect.

The Attorney General's other contention relating to the relative risk of the Barometer Group relates to the existence of the non-utility businesses of the Barometer Group companies (Attorney General RB at 43-44). As described in the Company's Initial Brief, the selection of the Barometer Group was based on a comprehensive relative-risk analysis for a five-year period (Company Initial Brief at 131-132, citing Exh. KEDNE/PRM-1, at 19-24). The fact that these businesses have some non-utility operations does not invalidate the proposition that the cost of equity for these companies

41 The standard deviation was computed using the following formula.

42 The average return on equity for each member of the group is the five-year average (1997-2001) of the returns set forth in Exhibit AG-5-1(a).

43 The coefficient of variation was computed by dividing the standard deviation by the average return on common equity.

are related primarily to the gas distribution business or that objective data, including the average earnings variability for these companies described above, indicates that the non-utility businesses of these companies do not elevate their cost of equity. The similarity of business risk (Exh. KEDNE/PRM-1, at 9-10) and credit quality risk (Exh. KEDNE/PRM-1, at 18) show that the Barometer Group has risk profile directly comparable to Boston Gas.

The Attorney General repeats his contention that the growth rate used by Mr. Moul in his DCF analysis is too high and that a 4 percent growth rate should be used (Attorney General RB at 44-45). The Company addressed this issue in its Initial Brief, and will not repeat its response in detail. In summary, the Attorney General's proposal is not based on record evidence in this proceeding and invalidly compares the growth for the Barometer Group used in a previous rate case (Company Initial Brief at 135-138). Moreover, using the Attorney General's own data, the growth rate is at least 5.73 percent (see the table on page 138 of the Company's Initial Brief). Accordingly, the Attorney General's proposal to apply a 4 percent growth rate is without merit and should be rejected by the Department.

Finally, the Attorney General proposes that the Department use the "most recent six months of information available to determine the DCF dividend yield" (Attorney General RB at 45). Although, in concept, the Company has no objection to using the latest available data to make the DCF calculation, as described by Mr. Moul on the record, the growth and dividend-yield data used in the DCF calculation must be from the same time period (Company Initial Brief at 138-139, citing Tr. 15, at 1952 [Moul]). The Department should therefore reject the Attorney General's "mix and match" approach to

choosing data and use information for the same time period for making the DCF calculation.

C. The Application of a Separate Return on Equity Calculation for Residential Customers Is Not Supported by this Record or Department Precedent.

Ignoring contrary record evidence and citing inapt precedent out of context, the Attorney General persists in his proposal, made for the first time on brief,[44] to set a lower cost of common equity for residential classes (Attorney General RB at 46-47). The Attorney General's citation to Department precedent in support of his proposal, Massachusetts Electric Company, D.P.U. 95-40, at 115-116 (1995), was made in the context of the allocation of purchased power costs in a cost-allocation study presented by Massachusetts Electric Company. In that case, the Department was considering different allocators for power costs, not establishing separate returns on common equity by rate class. Not surprisingly, the Department rejected the Attorney General's proposal in that case and noted the following:

> Commentators have noted, for example, that "any restructuring of rates based on risk differentials between customer groups must be founded on an investigation of the risks associated with serving the various customers, not on the basis of a general rule that one class of customers is less risky that another" (RR-DPU-83, Rohr and Stumpp, at 163). Others have concluded that "there appears to be little justification for charging different margins by rate classes" due to differences in risks of sales (RR-DPU-83, Spencer, Charles W. and Ruth J. Maddigan, "On Customer Class Rate of Return Differentials," based on twenty-year data for 58 U.S. utilities).

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[44] The record reflects no information requests, cross-examination of Company witnesses on cost of capital or cost allocation, or direct testimony from the Attorney General on the possibility of establishing rates based on different returns for classes. For that reason alone, the Department should reject the proposal.

Id. at 116, fn.58. In fact, the Attorney General again ignores the record evidence by the cost of capital expert that warned about the low load-factor for residential customers and the competition for residential customers from alternative energy sources, such as fuel oil (Tr. 15, at 1910 [Moul]; Exh. KEDNE/PRM-1, at 11).

There has been no serious attempt in this case to investigate the issue of whether the Department should depart from its long-standing goal of equalizing rates of return among rate classes. The Attorney General cites record evidence taken out of context and a single citation that is not on point with this eleventh-hour proposal.[45] Neither the Company nor the Department has had a fair opportunity to address this novel (and ultimately ill-conceived) proposal during hearings. The Department should reject the Attorney General's proposal to establish different rates of return by class.

D. Conclusion

The schedules appended to the Attorney General's reply brief underscore the devastating impact that the Attorney General's cost of capital proposals would have on the Company's credit quality. According to the Attorney General's own calculations, applying the 59.4 percent debt ratio and the 8.99 percent rate of return on common equity, the Company's overall rate of return would be 8.30 percent (Attorney General Reply Brief, Attachment 8). This would produce pre-tax interest coverage of 2.28 times. This coverage, along with the 59.4 percent debt ratio, would place Boston Gas in the BBB credit quality rating category. Exh. KEDNE/PRM-1, at 19. Thus, the Attorney General's cost of capital proposal would, if adopted by the Department, result in a downgrading of the Company's credit quality ratings. Exh. KEDNE/PRM-1, page 18. In

addition, it would not be comparable to the Barometer Group's A credit quality rating.[46] Such a decision would be inconsistent with Department precedent and the requirements under Hope and Bluefield. Instead, the Department should adopt the Company's cost of capital proposal as consistent with Department precedent and providing the Company with the opportunity to earn a reasonable return.

X. PERFORMANCE-BASED RATE PLAN

A. The Company's Proposed Performance Based Rate Plan Is Consistent With Department Precedent and Should Be Approved for Implementation

In his reply brief, the Attorney General contends that the Department should reject the Company's proposed PBR Plan because it fails to meet the Department's standards and does not comport with sound regulatory and economic policy (Attorney General RB at 54). The Attorney General further contends that the Company's PBR proposal has (1) raised administrative costs and review requirements; (2) would expand exogenous factor recoveries; (3) does not promote economic efficiency because it lacks adequate incentives for cost containment; (4) is unduly complex and unreviewable; and (5) suffers from false precision and methodological flaws (Attorney General RB at 55). All of these claims are without merit and the Company will address each claim in sequence.

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45 The citations to industry restructuring efforts, Department policies on interruptible transportation and the "benefits" of competition (Attorney General Reply Brief at 47-48) have no relevance to the Attorney General's proposal.

46 The pre-tax coverage must be in the 2.8x to 3.4x range and the debt ratio must be in the 47.5 percent to 53.0 percent range to maintain the Company's "A" credit quality (Exh. KEDNE/PRM-1, at 19).

Except for the values assigned to particular components of the price-cap formula, the Company's proposed PBR Plan is identical in all respects to the PBR Plan approved by the Department in D.P.U. 96-50 and D.P.U. 96-50-C. Therefore, with the exception of the values assigned to the components of the price-cap formula, there can be no dispute that the proposed PBR Plan complies with Department regulation and precedent.[47] In fact, the record shows that the Attorney General supports the adoption of the price-cap formula developed by the Department in D.P.U. 96-50 and D.P.U. 96-50-C. Exh. AG-41, at 30.

With respect to the Company's proposed price-cap formula, the record demonstrates that the proposal is in compliance with the Department's policy directives on PBR, which require PBR proposals to:

(a) Comply with Department regulations, unless accompanied by a request for a specific waiver;

⇨ Except for the values assigned to particular components of the price-cap formula, the Company's proposed PBR Plan is identical in all respects to the PBR Plan approved by the Department in D.P.U. 96-50 and D.P.U. 96-50-C. Therefore, the proposed PBR Plan complies with Department regulation and precedent

(b) Be designed to serve as a vehicle to a more competitive environment and to improve the provision of monopoly services, while avoiding the cross-subsidization of competitive services with revenues derived from monopoly services;

⇨ The Department has stated that incentive ratemaking mechanisms should be consistent with market-based competition and enhanced competition. D.P.U. 94-158, at 59. In that regard, the Company's PBR Plan is targeted at monopoly services, as was the prior PBR Plan and it avoids the cross-subsidization of competitive services with monopoly revenues

[47] Contrary to the Attorney General assertions, the Company is not requesting a change in the exogenous cost factor.

(c) Not result in reductions in safety, service reliability or existing standards of customer service;

⇨ The Department has stated that an incentive ratemaking mechanism should safeguard system integrity, reliability and other such policy objectives of the Department. Id. at 59. The Company is proposing to maintain its service-quality monitoring and measurement program consistent with the Department's generic SQI program.[48] Tr. 21, at 2766-2767. In addition, the record shows that the Company has significantly increased spending on mains replacement for system-reliability purposes. See Exhibit KEDNE/JFB-1, at 9-10; Exh. DTE-4-16, DTE-4-22. The record also shows that the Company will maintain its energy-efficiency and low-income programs. Exh. KEDNE/JFB-1, at 9-13).

(d) Not focus excessively on "cost recovery" issues; i.e., if a proposal addresses a specific cost recovery issue, its proponent must demonstrate that these costs are exogenous to the company's operations;

⇨ The Department has stated that incentive ratemaking proposals should not focus excessively on "cost recovery" issues; i.e., if a proposal addresses a specific cost recovery issue, its proponent must demonstrate that these costs are exogenous to the company's operations. D.P.U. 94-158, at 61. Like the first PBR Plan, the Company's plan is based on a price index, rather than cost factors. Significant cost changes are resolved through the exogenous cost mechanism, as they were in the first plan. The Company is not proposing any change to the definition of an exogenous change.

(e) Focus on comprehensive results; i.e., broad-based proposals should satisfy this criterion more effectively than narrowly-targeted proposals;

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[48] The Attorney General claims that the service-quality penalties associated with the Company's SQI plan, should be linked to the Company's PBR plan so that any SQI penalties applicable during the PBR Plan period would be incorporated in the base revenue levels to which the PBR adjustment is applied (Attorney General RB at 55). The Attorney General ignores the fact that the Department has conducted a full generic review of service-quality issues and has developed a comprehensive program of standards, benchmarks, measurements and penalties. Service Quality, D.T.E. 99-84 (2001). The Service Quality Program requirements and penalty mechanism developed by the Department are designed to function with PBR mechanisms, and therefore, is not distinguishable from a PBR service-quality mechanism. Nowhere in the Department's order establishing the service quality program is there any basis or support for the Attorney General's proposal. In fact, if the Attorney General's proposal in this regard were adopted, it would violate the provisions of G.L. c. 164 §1E(c), which authorizes the Department to establish service-quality penalties of up to 2 percent of a company's annual distribution revenues as part of a performance-based ratemaking plan. The penalty mechanism established by the Department encompasses a penalty formula that is based on 2 percent of distribution company revenues consistent with the statutes. Because of the compounding effect of the Attorney General's proposal, the proposal would effectively result in the imposition of penalties in excess of the statutorily allowed maximum level and would be contrary to, and in violation of, the provisions of G.L. c. 164 §1E(c).

⇨ The Department has stated that incentive ratemaking mechanisms should focus on comprehensive results. D.P.U. 94-158, at 62. The Company's proposal is a broad-based approach because it provides the incentive for the Company to manage costs in all areas of its operations

(f) Be designed to achieve specific, measurable results by identifying, where appropriate, measurable performance indicators and targets that are not unduly subject to miscalculation or manipulation;

⇨ The Department has stated that incentive ratemaking mechanisms should be designed to achieve specific, measurable results by identifying, where appropriate, measurable performance indicators and targets that are not unduly subject to miscalculation or manipulation. D.P.U. 94-158, at 63. The Department has further stated that "broader indicators are preferred" and that such indicators should include indicators of safety and reliability. Id. As stated above, the Company will maintain the service quality program, which includes indicators of safety, reliability and service to customers. See, e.g., Exh. AG-22-15, AG-22-16. In addition, the Company has provided significant evidence in this case of the Company's productivity and cost effectiveness. See, e.g., Exhibit KEDNE/LRK-3.

(b) Provide a more efficient regulatory approach, thus reducing regulatory and administrative costs (proposals should present a timetable for program implementation and specify milestones and a program tracking/evaluation method).

⇨ The Department has stated that an incentive ratemaking mechanism should provide a more efficient regulatory approach, thus reducing regulatory and administrative costs (proposals should present a timetable for program implementation and specify milestones and a program tracking/evaluation method). D.P.U. 94-158, at 64. As discussed in Exhibit DTE-6-4, the Company has avoided a base-rate increase for seven years as compared to the average of 2.5 years in the 10 years prior to the implementation of PBR. Therefore, the price-cap mechanism has had a significant impact on the reduction of administrative and regulatory costs.

Exh. DTE-6-7.

In this proceeding, the Department has a record before it that would allow it to adopt either the formula proposed by the Company or the formula espoused by the Attorney General. What the Department should not do in this case is abandon the PBR

framework in its entirety, as suggested by the Attorney General on brief. The Company has prepared and filed a PBR Plan as required by the Department. Fitchburg Gas and Electric Light Company, D.T.E. 98-51, at 5. The PBR Plan filed by the Company is entirely consistent with other plans adopted by the Department and any decision to eliminate PBR for the Company would not meet the reasoned consistency standard applicable to Department policy initiatives. The record shows that the rate of growth in expenses over the term of the first PBR Plan did, in fact, decrease. Exh. KEDNE/LRK-1, at 15; Exh. DTE-6-1. The Attorney General has not disputed or rebutted this record evidence.

B. The Company Has Demonstrated that Its Proposed PBR Plan is Well Supported and Reviewable and Is Not Flawed

In his reply brief, the Attorney General repeats his initial comments contending that the model presented by the Company is "unreviewable" and flawed. The Company will not repeat its arguments from the Initial Brief because the claims of the Attorney General are not supported by the evidence in the record. The models presented by the Company are, in all major respects, the same as those reviewed and approved by the Department in D.P.U. 96-50. Therefore, the Attorney General's claims in this regard are without merit

C. There is No Requirement for the Company to Demonstrate that Northeast Productivity Growth is Less Than the Nation's

The Attorney General misrepresents the Company's position regarding the use of the Northeast definition of the gas distribution industry. The Attorney General claims that "the Company seems to suggest that the DTE must accept its Northeast productivity study, because the Department 'accepted a regional definition of the gas distribution

industry' in D.P.U. 96-50." The Company has never asserted that the Department "must" do any such thing. Rather, it has noted that in D.P.U. 96-50, the Department reached the conclusion that a Northeast definition of the gas distribution industry was appropriate, and it justified this decision on the basis of very specific evidence (a positive coefficient on a Northeast dummy variable in an econometric model of gas distribution costs). In preparing its PBR filing, the Company investigated whether the evidence that the Department used to reach this conclusion remained true, and it found that it did. The Company therefore concluded that a regional definition of the gas distribution industry remained valid, and the rationale upon which this decision was based was also in accordance with Department precedents.

In addition, the Company presented other analytical reasons to expect TFP growth to differ between the Northeast gas distribution industry and the rest of the US gas distribution industry. Exh. RR-DTE-124. The Attorney General has not disputed these analytical reasons, nor offered any explanation for why the Department should abandon the precedent established in D.P.U. 96-50, especially when the Company has presented evidence that confirms the rationale on which that precedent was based.

D. The Company Has Not Violated Alleged Staffing Level Requirements

The Company is not in violation of the staffing requirements as claimed by the Attorney General (Attorney General RB at 62). The Company's current staffing levels are fully consistent with effective collective bargaining agreements, and the Attorney General has cited to no evidence to the contrary. Moreover, the Attorney General did not pursue this issue during the hearings and there is no record support upon which the

Department could levy the penalty sought by the Attorney General, and therefore, the Attorney General's claims must be rejected.

E. DOER's PBR Proposal is Flawed and Without Record Support

In their Reply Brief, DOER reargues their initial claims that the PBR should: (1) be adjusted to take into account regional differences for the natural gas industry using the Producer Price Index; and (2) include a clawback mechanism in order to compare the Company's average, annual productivity change over the term of the PBR plan to an established benchmark. As discussed in the Company's initial brief, DOER's proposals are flawed and without any evidence in the record. Because there is no evidence upon which the Department could base a decision to adopt these proposals, all of these claims must be rejected by the Department.

Respectfully submitted,

KeySpan Energy Delivery New England d/b/a Boston Gas Company

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